83-183

No. 83-

IN THE

Supreme Court of the United States

OCTOBER TERM, 1983

LTV FEDERAL CREDIT UNION,
Petitioner

v.

UMIC GOVERNMENT SECURITIES, INC., and
BANCO DE LA NACION ARGENTINA,
Respondents

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

JIM K. CHOATE
Counsel of Record

JOHN P. LILLY

BRICE AND BARRON,
a Professional Corporation
Suite 3858, 2001 Bryan Tower
Dallas, Texas 75201
(214) 748-6412

ATTORNEYS FOR PETITIONER

QUESTIONS PRESENTED

1. Prior to the 1982 Congressional amendments to the definition of a "security", were options, puts, calls and straddles on securities, including exempt securities, subject to the Federal Securities Laws?

2. Should the Court of Appeals have applied the then existing definitions of securities, as amended by Congress in 1982, when deciding this case in 1983 rather than its interpretation of the pre-amendment law?

3. Is an unregistered, unlicensed securities broker/dealer who provides facilities and makes a market in securities by bringing buyers and sellers together an "Exchange" as defined by the Securities Exchange Act of 1934? (a matter of first impression)

4. Is a Federal Credit Union authorized by the Federal Credit Union Act to enter into options on securities where the Act does not specifically so provide? (a matter of first impression)

5. Should the Court of Appeals have applied the federal regulation prohibiting federal credit unions from entering into standby option contracts as promulgated in 1979 in this case when decided in 1983?

LIST OF PARTIES

1. LTV Federal Credit Union, Dallas County, Texas, Petitioner

2. UMIC Government Securities, Inc. (and UMIC, Inc., its parent corporation), Memphis, Tennessee, Respondent

3. Banco de la Nacion Argentina, New York, New York, San Francisco, California, Respondent

TABLE OF CONTENTS

TABLE OF AUTHORITIES

TABLE OF AUTHORITIES (Continued)

TABLE OF AUTHORITIES (Continued)

TABLE OF AUTHORITIES (Continued)

IN THE

Supreme Court of the United States

OCTOBER TERM, 1983

LTV FEDERAL CREDIT UNION,

Petitioner

v.

UMIC GOVERNMENT SECURITIES, INC., and
BANCO DE LA NACION ARGENTINA,

Respondents

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

Petitioner LTV Federal Credit Union respectfully requests that a Writ of Certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Fifth Circuit entered on May 6, 1983 in Case No. 81-1533.

OPINIONS BELOW

The opinion of the Court of Appeals in No. 81-1533, which is reproduced in the Appendix beginning at page A-1, is reported at 704 F.2d 199 (5th Cir. 1983). The opinion of the United States District Court for the Northern District of Texas, which opinion was adopted by the Court of Appeals, is reproduced in the Appendix beginning at page B-1, and is reported at 523 F.Supp. 819 (1981).

JURISDICTION

The judgment of the Court of Appeals was entered on May 6, 1983. This petition was filed within 90 days of that date. The jurisdiction of this Court is invoked under 28 U.S.C. Section 1254(1). Jurisdiction in the District Court was conferred by 15 U.S.C. Section 77v, 15 U.S.C. Section 78aa, and diversity with an amount in controversy exceeding $10,000 exclusive of interest and costs.

STATUTES AND REGULATIONS INVOLVED

This case involves questions arising under the Securities Act of 1933, the Securities Exchange Act of 1934, the Federal Credit Union Act, the corresponding Federal Code of Regulations issued pursuant thereto, the corresponding Texas Blue Sky Law, and the Gaming and Bucket Shop Statutes of the State of Tennessee. These are codified as follows:

> 12 U.S.C. Sec. 24; 12 U.S.C. Sec. 1757; 12 U.S.C. Sec. 1757 (7); 15 U.S.C. Sec. 77b; 15 U.S.C. Sec. 77e; 15 U.S.C. Sec. 77 l; 15 U.S.C. Sec. 77p; 15 U.S.C. Sec. 77q; 15 U.S.C. Sec. 77v; 15 U.S.C. Sec. 78c (1) (1); 15 U.S.C. Sec. 78e; 15 U.S.C. Sec. 78g; 15 U.S.C. Sec. 78i; 15 U.S.C. Sec. 78j; 15 U.S.C. Sec. 78o; 15 U.S.C. Sec. 78aa; 15 U.S.C. Sec. 78cc; 12 CFR Sec. 703.3 (a) (2); 12 CFR Sec. 703.3 (b) (2); 12 CFR Sec. 703.3 (b) (3); 17 CFR Sec. 240.10 (b) -5; Vernon's Annotated Texas Statutes, Articles 581-1 et. seq. 581-39; and Tennessee Code Annotated Section 39-2020; Section 39-2021; and Section 39-2023.

The pertinent portions of all statutes and codes referred to in the petition are set forth in the Appendix and indexed in the table of contents thereto.

STATEMENT OF THE CASE

Proceedings and Disposition in the Courts Below. This suit was filed in the United States District Court for the Northern District of Texas, Dallas Division, by Plaintiff LTV Federal Credit Union (LTV). LTV filed suit seeking a declaratory judgment that a certain agreement denominated a "Standby Commitment" was unenforceable because, *inter alia,* the agreement was a "security" sold in violation of federal and state securities laws, that LTV lacked statutory authority to enter such an agreement, and that the defendant operated as an unregistered securities exchange.

The defendant was UMIC Government Securities, Inc., a Tennessee corporation, with its principal office located in Memphis, Tennessee (UMIC). UMIC later filed a Complaint alleging anticipatory breach of a contract, which was transferred and consolidated with the action filed by LTV.

Thereafter Banco de la Nacion Argentina, an agency of the Republic of Argentina (Banco), with branches in New York and San Francisco, filed a Motion to Intervene as Plaintiff against UMIC, on virtually the same grounds as LTV, including fraud. UMIC and Banco then settled by assignment of a part of UMIC's counterclaim and Banco withdrew its complaint and was joined with UMIC. The case was tried without a jury and judgment against LTV and in favor of UMIC and Banco was entered. 523 F.Supp. 199 (1981). LTV appealed. The Court of Appeals affirmed, expressly adopting the District Court's opinion. 704 F.2d 199 (1983).

Both courts held that the option on GNMA securities was not a security. The circuit court also refused to apply the 1982 amendments to the Securities Acts of 1933 and 1934 in which Congress specifically included in the definitions of securities "options" on securities. These amendments were passed while

the case was pending argument in the Court of Appeals. Likewise both courts refused to apply the current federal regulation declaring it to be illegal for federal credit unions to enter into standby option contracts exactly like the one in issue in this case. The Court of Appeals overruled all Petitioner's grounds, including its argument that UMIC was an unregistered exchange.

Nature of the Case. The case involves two written agreements or options to sell securities known as GNMA's (Ginnie Maes).[1] These options were drawn up by UMIC on their standard printed forms and designated as "Standby Commitments" (Standbys). UMIC sold one Standby to Banco (the Banco Standby). For a fee ($240,000) UMIC agreed to purchase, at Banco's option, $4,000,000 principal amount (plus or minus 2.5%) of 8½% GNMA securities at a price of 101% of principal, to be delivered and paid for July 22, 1980.[2] UMIC then subsequently entered an almost identical Standby (the LTV Standby) which it solicited and purchased from LTV (for $200,000) whereby UMIC could sell a like number of GNMA's to LTV to "cover" UMIC's exposure should Banco exercise its option to sell to UMIC. UMIC could and did require LTV to put up a "margin," but Banco had no right to require a margin of UMIC. These are referred to as "paired transactions" and are commonly known as put options in the securities industry.[3]

Facts in the Record Necessary to Understand the Issues. LTV is a federally chartered corporate-sponsored credit union, with capital composed principally of member's deposits. Its board

---

[1] Government National Mortgage Association mortgaged-backed pass-through certificates.

[2] By custom, however, UMIC and Banco could settle out without delivery as they had in the past.

[3] A call option gives the holder the right to purchase a specific quantity of the underlying security from the writer of the options contract at a specified price during the life of the option. A put option similarly gives the holder the right to sell a specific quantity of the underlying security to the writer of the options contract. See generally Report of the Special Study of the Options Markets to the SEC 73-75 (Comm. Print 96-IFC3 1978).

consisted of past and present employees of its corporate sponsor who, at the times involved, had no formal training or previous experience in banking, securities, investments or mortgage banking. The credit union manager (the only paid officer or director) who entered into the Standby Agreement in question with UMIC had no formal education after high school, and no training or experience with investments or the investment activities of LTV prior to becoming the manager.

UMIC was organized in March 1978, with offices in several states. UMIC was not registered as a broker or dealer under any state or federal securities law, was not a member of any exchange or board of trade, and was never registered as a securities exchange. UMIC employed approximately 100 salesmen who operated in an area referred to as the "brokerage floor" in which numerous salesmen, using telephones, sought to move securities listed for sale or purchase on blackboards by finding purchasers and sellers in telephone calls. UMIC employees testified that UMIC "made a market" by "bringing buyers and sellers together," mostly in government securities. None of these transactions were ever effected through a recognized exchange.

Banco had traded with UMIC, primarily in short term futures contracts on GNMA's which were settled without delivery, "on the margin" for a number of years at the time of the transactions herein. Banco had lost money and was indebted to UMIC.

After entering the Banco Standby, UMIC's salesman (formerly a used car salesman) solicited LTV to enter the LTV Standby. UMIC did not explain any of the inherent risks or present a copy of the proposed Standby to LTV. There was no discussion about the "yield maintenance clause"[4] or its operation

[4] The LTV Standby Option Agreement contained the following language:

In the event that the F.H.A. Mortgage Rate is changed during the term of this commitment, we may deliver GNMA securities bearing a corresponding change from the securities interest shown above. In this event we will deliver the new rate securities at a price which will produce the same yield as provided by this contract. (Yields to be calculated on the basis of Prepayment in 12 years).

or "margin" requirements. UMIC did not disclose that the LTV Standby was paired with Banco. Both Standby Agreements were thereafter prepared by UMIC, dated June 26, 1978, and both were signed as of that date. Both had the same settlement date, July 22, 1980. The effect of this was that if mortgage interest rates went up by July, 1980, Banco would elect to give notice of delivery because they would make a profit. UMIC would likewise give notice to LTV because it was not financially able to sustain a loss. UMIC never had sufficient assets or reserves to fund this transaction and this was not disclosed to LTV. Thus LTV would stand the entire loss. Conversely, if interest rates went down, neither Banco nor UMIC would exercise the put to LTV. LTV could not reasonably expect to profit more than the initial $200,000 it had received but could, and in fact has, suffered a far greater loss.

UMIC's salesman believed interest rates were going to go up, but he did not disclose this to LTV, nor did he tell LTV about Banco. UMIC had none of its funds in the transaction as it had received $240,000 for the Banco Standby.

Just weeks after both Standbys had been executed, the Agency Administrator of the National Credit Union Administration (NCUA) publicly stated that standby contracts were in essence put options, futures, and thus separate securities from the underlying lawful securities and were *unlawful* for credit unions. On October 17, 1978, a notice of proposed rules to this effect was published in the Federal Register, Vol. 43, No. 201, (App. F-1). Until LTV contacted attorneys following a margin call, LTV was unaware of the risks involved in the "yield maintenance clause" in the LTV Standby, especially that UMIC using that clause might choose to deliver something other than 8½% GNMA's increasing the cost under the LTV Standby to $5,000,000 or more instead of the $4,000,000 set forth in the LTV Standby. By March 24, 1980, UMIC had been informed by LTV's attorneys

that their margin call was "unenforceable." and further that LTV could not honor the Standby because it was an illegal contract for a federal credit union. UMIC then, for the first time, advised LTV that they intended to deliver *not* 8½% GNMA's, but rather 12½% GNMA's at a cost to LTV of $5,873,600. UMIC also revealed the paired Standby for the first time and alleged, falsely, that UMIC was under an unconditional obligation to purchase and pay in cash for the same GNMA securities which LTV was committed to purchase from UMIC.[5] On June 17, 1980, UMIC demanded performance from LTV. LTV offered rescission which was "flatly refused" by UMIC. UMIC also refused to identify the other party, Banco, so the matter could be resolved before anyone had suffered a great loss.[6] On June 24, 1980, LTV filed its Complaint seeking a declaratory judgment that the Standby with UMIC was unenforceable. The next day, June 25, 1980, UMIC filed suit against LTV for breach of contract.

---

[5] This statement was not in fact true since Banco did not give written notice to UMIC of its intent to deliver until June 12, 1980. UMIC, on June 11, 1980, sold to Banco for $4,240,000, $4,000,000 par value, of GNMA 10%'s, a price above market, to be delivered in July. This was supposedly done "in order that Banco would have GNMA's available to it to deliver to UMIC on July 22, 1980," the settlement date under both Standby Commitments. UMIC had not told Banco that LTV would not accept the delivery from UMIC, and at this time UMIC was not financially able to purchase $4,000,000 in GNMA's. UMIC's balance sheet for June 1980 shows total net assets of $345,000. The July 1980 shows total net assets had dropped to $170,000.

[6] Banco did not discover any of this until July 15, 1980. Banco not knowing of the dispute took delivery and paid UMIC in excess of $4,240,000 for GNMA securities. They were not however 8½% GNMA's; they were instead 10% GNMA's. On July 3, 1980, UMIC sent a Mailgram to Banco noting that Banco had *not* properly elected to deliver the GNMA's under the Banco Standby to UMIC and thereafter refused to honor the Banco Standby with Banco while insisting that LTV honor the LTV Standby. Thus, instead of simply passing Banco's GNMA on to LTV, which would have left UMIC with only its original $40,000 commission, UMIC could now reap the entire profit of well over $1,500,000, which so far they have.

REASONS FOR GRANTING THE PETITION

THE OPINION OF THE COURT OF APPEALS THAT OPTIONS ARE NOT SECURITIES IS INCONSISTENT WITH ACTION BY THE CONGRESS, INCONSISTENT WITH HOLDINGS OF THIS COURT AND OTHER COURTS WITH THE RESULT THAT THE COURT OF APPEALS HAS HELD THAT ALL OPTION TRANSACTIONS ON SECURITIES PRIOR TO THE CONGRESSIONAL AMENDMENTS ARE EXEMPT FROM THE SECURITIES LAWS

The Court of Appeals and the District Court held in this case that the LTV Standby, an option contract on GNMA securities, was not a security under the federal securities laws. In doing so, the Court of Appeals is in direct conflict with decisions of this Court, the Sixth Circuit, the Ninth Circuit, the Tenth Circuit, and numerous district courts, the Supreme Court of Texas and the expressed intent of Congress.[7]

Prior to argument before the Court of Appeals in this case, this very issue was decided by the Court of Appeals for the Seventh Circuit in *Board of Trade of City of Chicago v. S.E.C.*, 677 F.2d 1137 at 1155-1159 (1982) holding that option contracts on GNMA's are not securities. The Seventh Circuit had cited the District Court's opinion under review herein as authority. *Id.* at 1158.[8] That decision provoked a furor in both the securities industry and Congress. Petitions for Writs of Certiorari in *Board*

---

[7] Cases cited and discussions herein at pages 11 to 14 *infra*.

[8] As the Seventh Circuit relied heavily in *Board of Trade* upon the opinion of the District Court in this case to support its holding that an option on a GNMA is not a security and the Fifth Circuit now relies on *Board of Trade* in its opinion, the actual effect of this anomaly is to have the District Court's opinion in this case serve as authority to sustain the District Court's opinion in this case.

of Trade and a companion case were promptly filed in this Court.[9] During the pendency of these Petitions, Congress acted specifically to overturn the decision in *Board of Trade* by amending the 1933 and 1934 Securities Acts expressly to include, *inter alia*, options on securities within the definition of a "security" in both the 1933 and 1934 Securities Acts by inserting the following additional language: ". . . any put, call, straddle, option or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof) . . . ." Pub.L. No. 97-303, 96 Stat. 1409 (now codified at 15 U.S.C. Sections 77b(1), 78c(a)(10), 78(i), 78bb(a), 78 lll(14), 80a-2(a)(18) and 80a-2(36)) (App. F-15 and F-16). As set forth in the legislative history (App. C-1), this action by Congress was a dramatic statement of its belief that options on securities had always been securities within the meaning of the federal securities laws. Even the Court of Appeals in its opinion recognized Congressional attitude:

> "On the other hand, the legislative history of the bill, embodied in a rather lengthy House Energy and Commerce Committee report, is laced with such phrases as 'clarification of SEC jurisdiction,' 'long-standing Congressional intent that the SEC has the sole authority to regulate options on all securities, including exempted securities,' and 'confirm the intent of Congress.' H.R. Rep. No. 97-626, 97th Cong., 2d Sess. 2, 8, 9, U.S. Code Cong. & Admn. News 1982, pp. 2780, 2786-87." 704 F.2d at 202. (App. A-7-8)

Yet the Court of Appeals gave no weight whatsoever to this expressed intent of Congress in its consideration of this case, stating: "This *clarification* terminology is not in itself dispositive of the issue before us," and "*congressional commentary*

---

[9] See Petitions for Writs of Certiorari filed with this Court in the *Board of Trade* cases: No. 82-237 *Chicago Board of Options Exchange, Incorporated and The Options Clearing Corporation v. Board of Trade of the City of Chicago* and No. 82-526 *Securities and Exchange Commission v. Board of Trade of the City of Chicago and Chicago Board of Options Exchange, Inc.*

notwithstanding, it was *not clear* that an option on an exempt security (GNMA's) was itself a security for purposes of registration prior to the 1982 amendments." 704 F.2d at 202 (App. A-8) (emphasis added).

The Court of Appeals below relied heavily upon the *Board of Trade* case to reach its position that the issue was "not clear." 704 F.2d at 202.(App. A-9). In relying on the *Board of Trade* case after Congress had expressly attempted to legislate it out of existence, the Court of Appeals ignores the Congressional expressions of intent unavailable to the Seventh Circuit and the District Court herein at the time they construed these definitions and statutes.[10] The Court of Appeals had such guidance from Congress, but failed to even reanalyze the District Court's interpretation.

Given this confirmation of this intent of Congress together with the previously decided cases from other courts, it is obvious that an option on a GNMA security was itself a security even prior to the 1982 Congressional Amendments. This point was extensively briefed and presented to this Court in the petitions for writs of certiorari filed in *Board of Trade* . The SEC, the Securities Industry Association, the Chicago Board of Options

---

[10]The Congress was quite explicit in its intent to specifically overturn the holding of the Seventh Circuit. In its report recommending enactment of this legislation, the Committee on Energy and Commerce stated: "Although the word 'option' is not explicitly included in the definition of 'security,' a call option on a security is a 'right to purchase' a security and both put and call options [on] securities are considered instruments 'commonly known as' securities." House Rep. No. 626, 97th Cong., 2d Sess. Part I at 3 (1982) (App. C-3). The House Committee also stated its belief that the decision by the Seventh Circuit Court of Appeals 'is not consistent with long-standing Congressional intent that the SEC has the sole authority to regulate options on all securities, including exempted securities." Id. at 6 (App. C-6). The Report of the Senate Committee on Banking, Housing, and Urban Affairs similarly stated that the "comprehensive authority [of the SEC] to regulate securities extends to put and call options on securities" and that options "currently are considered to be within the definitions of 'security'" in the federal securities laws. S. Rep. No. 390, 97th Cong., 2d Sess. 3.5 (1982).

Exchange, Inc., and the Options Clearing Corporation all strongly opposed the Seventh Circuit's holding that an option on a GNMA was "not a security."[11] After the Congressional Amendments, on a suggestion of mootness filed in this Court, a dispute arose between the Petitioners and the Respondent in *Board of Trade* as to whether the Seventh Circuit's opinion should be vacated, because although the jurisdictional dispute between the SEC and the Board of Trade had been resolved, the confusion created in the securities industry and the case law was far reaching and that failure to vacate the Seventh Circuit's judgment and thus nullify its opinion would leave more questions unresolved than had been settled.[12] Apparently this Court concurred for it granted the Petitions and then vacated the judgment of the Seventh Circuit, remanding the case to be dismissed as moot. ______ U.S. ______, 103 S.Ct. 434 (1982).

The District Court's opinion analyzes the entire issue of whether the LTV Standby was itself a "security" based on its erroneous analogy of the Standby to a commodity futures contract, the very same erroneous approach used by the Seventh Circuit in *Board of Trade*. The District Court completely ignores that the Standby was, in essence, a one-way "option" with no ready market in which LTV could sell the "contract" prior to "delivery" to cut its losses. The risks in commodities futures contracts on "real" commodities are entirely different from the risks involved in the LTV Standby. By focusing on the "commodity" issue in its securities law analysis, the District Court, and thus the Court of Appeals, *never* properly analyzed the LTV Standby as a "security."

By jumping directly to the issue of retroactive application, the Court of Appeals has not addressed, except by adoption of the District Court's opinion, the most important issue in the case: whether such options on securities, including otherwise exempt

[11] *Supra*, Note 9.

[12] See Reply Briefs of Petitioners in *Board of Trade*, No. 82-327 and No. 82-526, *supra*, Note 9.

securities, were in fact within the definition of a "security" *prior to* the Congressional Amendments. A review of cases on this point illuminates a conflict between the Seventh Circuit's vacated opinion in *Board of Trade* and the Fifth Circuit's opinion herein and numerous other decided cases: the Sixth Circuit Court of Appeals, which held that the definition of security in the Securities Exchange Act "clearly includes options to purchase or sell stock." *Mansbach v. Prescott, Ball & Turben*, 598 F.2d 1017, 1026 (1979); the Ninth Circuit which held that naked double options to buy and sell commodity futures contracts were securities as defined by the Securities Act of 1933. *S.E.C. v. Commodity Options International, Inc.*, 553 F.2d 628 (1977); the Tenth Circuit which held that a "standby" or "take out" commitment to pick up a mortgage loan was a security as defined by the Securities Act of 1933. *United States v. Austin*, 462 F.2d 724, 736 (1972); and the Supreme Court of Texas which held under Texas Securities Laws that options on commodities were securities, citing many federal cases. *Searsy v. Commercial Trading Corp.*, 560 S.W. 2d 637, S.Ct. 1978. The great majority of federal district courts have likewise agreed that options on securities are separate securities.[13]

---

[13] See, e.g., (1) *In re McDonnell Douglas Corp. Securities Litigation* [Current Binder] Fed. Sec. L. Rep. (CCH) ¶98,737, at 93,723 (E.D. Mo. June 22, 1982); (2) *Backman v. Polaroid Corp.*, 540 F. Supp. 667, 671 (D. Mass. 1982) ("Call options are securities within the meaning of Section 10(b) * * *." (3) *O'Connor & Associates v. Dean Witter Reynolds, Inc.*, 529 F. Supp. 1179, 1186 (S.D.N.Y. 1981); Savino v. E. F. Hutton & Co., 507 F. Supp. 1225, 1235 (S.D.N.Y. 1981) ("the * * * stock options that defendants purchased and sold * * * undoubtedly constituted 'securities.' "); (4) *Lloyd v. Industrial Bio-Test Laboratories, Inc.*, 454 F. Supp. 807, 822 (S.D.N.Y. 1978) ("Calls have been explicitly and implicitly recognized as securities"); (5) *Lubin v. Belco Petroleum Corp.*, [1978 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶96,543, at 94,237 (S.D.N.Y. Aug. 24, 1978) ("An option to buy or sell a security involves investment risks paralleling those entailed in ownership of the underlying security and is thus a security itself." (6) *Piemonte v. Chicago Board Options Exchange, Inc.*, 405 F. Supp. 711 (S.D.N.Y. 1975) (recognizing that standardized options traded on the CBOE are separate securities subject to separate registration and investor disclosure requirements under the securities laws; (7) *Vogel-Lorber, Inc. v. Options on Shares, Inc.*, [1974-75 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶94,911, at 97,109 (S.D.N.Y. Dec. 9, 1974)

It would likewise appear that the Fifth Circuit in ignoring the actions of Congress and this Court taken in response thereto has created a direct conflict with the action of this Court in vacating *Board of Trade*.[14] In its opinion, the Court of Appeals does not even mention that this Court had vacated that opinion on November 29, 1982.

The practical effect of leaving the judgment and opinion of the Court of Appeals (and the District Court's opinion which was adopted) on the books is to substitute it for that of the Seventh Circuit in *Board of Trade*. This would create great uncertainty in numerous regulatory enforcement areas where "options" on securities have been either by statute, regulation or industry practice treated as securities. As pointed out by the Securities Industry Association in its motion and *amicus curiae* brief filed in *Board of Trade*, at pp.7-11, many members are brokers and dealers in both securities and commodities, and there are different rules for margin, registration and suitability. The House Committee on Energy and Commerce in its report in support of the confirming legislation, points out additional areas where confusion has been created by the decision that an option on a security is not a security itself. (App. C-1). The Fifth Circuit's holding in this case, if allowed to stand, means that only in those cases arising after October 13, 1982 (the effective date of the 1982 amendments) are such options on securities to be treated as within the protective umbrella of all of the federal securities laws and related regulations. Even worse, the opinion could remove the prior protection of these laws as applied to options.

("it is apparent that the SEC intended that options be considered as securities * * *."); (8) *Globus, Inc. v. Jaroff*, 271 F. Supp. 378, 380 (S.D.N.Y. 1967) ("It is axiomatic that * * * an option agreement is a security under the 1934 Act * * *"); (9) *SEC v. Texas Gulf Sulphur Co.*, 258 F. Supp. 262, 292 (S.D.N.Y. 1966) rev'd in part on other grounds, 401 F.2d 833 (2d Cir. 1968) (en banc), cert. denied, 394 U.S. 976 (1969) ("A stock option is a security * * *.").

[14] See also, *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 95 S.Ct. 1917 (1975), which has been repeatedly cited for the proposition that options are themselves securities.

The Court of Appeal's opinion creates an entirely new exempted security, one not enumerated in the statute:

> "And even if the standby commitment is considered a 'security' then as a 'stock option' in GNMA's, it is no more subject to registration than the underlying GNMA's. 704 F.2d at 201. (App. A-4, 5).
>
> "It cannot be said that options on exempt government securities were so considered separate securities for purposes of registration prior to the 1982 amendments." 704 F.2d at 203. (App. A-11).

The LTV Standby was issued by UMIC and prepared on printed forms of UMIC. It was *not issued by nor was it guaranteed by any agency or quasi-agency of the United States Government.* It involved risks separate and apart from the GNMA securities which formed the subject of the option but which in fact furnished only the market quotations necessary to determine who lost or won and by how much.

Thus, this case now stands as the last definitive statement by a federal appellate court on this issue. The decision calls into question the SEC's regulation of all options. Since 1973, the Options Clearing Corporation has registered options on securities in accordance with the registration provisions of the Securities Act. The impact of such a result is staggering. For example, in 1980 over 80 million options with a value in excess of $41 billion were traded on the CBOE and other exchanges. The Court of Appeals' opinion calls into question the appropriate regulatory scheme for all such trading and can only cause economic mischief to the major securities exchanges of this country and to the industry. See Brief *Amicus Curiae* of the Securities Industry Association, in No. 82-327, p.9, *supra* note 9.

THE COURT OF APPEALS DECISION ON RETROACTIVE APPLICATION OF STATUTORY CHANGES IS DIRECTLY CONTRARY TO AND MISINTERPRETS DECISIONS OF THIS COURT

The Court of Appeals opinion, Part II, is directly in conflict with the consistent line of decisions from this Court for the last 182 years on the issue of retroactive application of statutory changes which occur during the pendency of direct review. Beginning with *United States v. Schooner Peggy*, 1 Cranch 103, 2 L.Ed. 49 (1801) extending consistently through *Thorpe v. Housing Authority of City of Durham*, 393 U.S. 268, 89 S.Ct. 518, 21 L.Ed. 474 (1969) and *Bradley v. School Board of City of Richmond*, 416 U.S. 696, 40 L.Ed. 476, 94 S.Ct. 2006 (1974), the general rule has consistently been that an appellate court on direct review is to apply the law in effect at the time of its decision, not the law in effect at the time of the trial court's decision or the transaction. In *Bradley*, this Court stated: "*Thorpe* stands for the proposition that even where the intervening law does not explicitly recite that it is to be applied to pending cases, it is to be given recognition and effect." 416 U.S. at 715, 94 S.Ct. at 2018.

The Court of Appeals has misconstrued 182 years of this Court's decisions to completely "shift the burden" on retroactive application from the general presumption of *Thorpe* and *Bradley* to a restrictive application only in cases "vindicating rights of great national concern." This approach dramatically changes the analytical approach to retroactive application by limiting the presumption to matters of "great national concern" and unduly enhancing the "manifest injustice" exception by virtually presuming that such injustice will result if retroactive application destroys a cause of action between private litigants.[15] In virtually

---

[15] The Court of Appeals has misread the clear import of this Court's language in *Gulf Offshore Co. v. Mobil Oil Corp.*, 453 U.S. 473, 101 S.Ct. 2870, 69 L.Ed. 784 (1981) at note 16, by reading the dicta in that note as a

every instance where retroactive application of a change in a statute or regulation is considered by a court, application of the change will create or take away something affecting an existing "right," quite often the cause of action itself. This Court should clearly reestablish the general rule and clarify the parameters of the "manifest injustice" exception in *Thorpe* and *Bradley*. To leave the Court of Appeals opinion in place would rewrite 180 years of jurisprudence.

First, Petitioner submits that the legislative history cited herein[16] clearly shows that Congress intended its action to apply to all pending litigation. Just as this Court noted in *Bradley*, the legislative history "would seem to provide at least implicit support for the application of the statue to pending cases." 416 U.S. at 716; 94 S.Ct. at 2281.

Having shifted the emphasis away from the general rule, the Court of Appeals then interprets the facts under the "exception" to reach its result. *Bradley* recognizes the "manifest injustice" exception but suggests that a court should consider the following factors in analyzing its applicability: (a) the nature and identity of the parties; (b) the nature of their rights; and (c) the nature of the impact of the change on law upon those rights. 416 U.S. at 717, 94 S.Ct. at 2019.

In analyzing the exception, the Court of Appeals first incorrectly characterizes "the nature and identity of the parties." The record reflects that the management of LTV was anything but financially sophisticated. LTV was a small credit union for corporate employees. Its board members were present or past employees of the sponsoring corporation with no formal training or previous experience in banking, securities, investments or mortgage banking. LTV's manager, who entered the LTV

---

negative pregnant, i.e., that if the retroactive application would extinguish the cause of action, the statute should not be applied retroactively, thus shifting the emphasis from the general rule and the "manifest injustice" exception to an objective standard — loss of cause of action — which has *never* controlled the issue.

[16] See argument and authorities at pages 8 to 11 *supra*.

Standby, had no formal training beyond high school, and other than his employment with LTV had no prior training or experience with investments or the investment activities of LTV. On the other hand, UMIC operated as an unlicensed, unregulated and unregistered dealer/broker engaged in multinational unregulated trading of options in government securities. UMIC was not a member of any exchange or board of trade, making its "market" on the side. UMIC had over 100 "salesmen" who received "training" in UMIC's boiler room operation. It is patently obvious that UMIC's activities had been carefully developed by its principals and attorneys to take advantage of a perceived "loophole" in the statutory regulation of securities trading.[17] Thus, the Court of Appeals has relied on incorrect assumptions concerning the first element of the *Bradley* analysis by not truly understanding the nature and identities of the parties.

Likewise, the Court of Appeals is incorrect in its assumption that only "purely private" rights are involved in this case and that retroactive application would *unduly* prejudice rights of UMIC. First, that conclusion overlooks the very nature of UMIC's activities and assumes that the activities of UMIC were clearly lawful at the time of the LTV contract, despite the fact that it concluded that the issue of such commitments as securities

---

[17] Federally chartered corporate credit unions are not, in general, bastions of financial sophistication. Unlike the Court of Appeals, the drafters of the Report of the Joint Treasury — SEC — Federal Reserve Study of the Government-Related Securities Markets (App. D-1) recognized the relative unsophistication of small credit unions, especially in connection with GNMA "forward commitments." (Report, pp. 107-110, App. D-20 to 22). The Report also analyzes numerous of the abuses by unregulated sales operations just like UMIC, clearly falling within the very abuses alleged by LTV to have been committed by UMIC in this action. (Report, pp. 110-118, App. D-22 to 27). In recognition of the relative naivete of credit unions, the Congress and National Credit Union Administration have imposed severe restrictions on the suitability of the various investments for such credit unions. *Within weeks* after the LTV Standby was signed, the Administrator of the NCUA stated that such GNMA standby options were unlawful for credit unions. Shortly thereafter, the NCUA published proposed rules to this effect. See discussion at pp. 22 to 26, *infra*.

was uncertain under existing case law. 704 F.2d 203 (App. A- 11). Thus the Court of Appeals bases its rationale on what it mistakenly decided was a contested and unresolved issue of statutory interpretation. A primary issue, which this Court has not yet passed upon directly is whether or not the federal securities laws prohibited UMIC's activities even prior to the 1982 Congressional Amendments. Irrespective of how *that* issue is decided, there can be no question that UMIC *had to know* that it was walking a *very* thin line and relying on a highly questionable private interpretation of the federal securities laws at the time it contracted with LTV.[18]

By June 1978, the various regulatory agencies had begun to recognize the threat posed by UMIC's interpretation of the exemption for government guaranteed securities.[19] UMIC is no innocent lamb which would be unfairly slaughtered by retroactive application. The *very purpose* of the federal securities laws has been to protect investors from traders like UMIC. No citation is necessary for the proposition that decisions of this Court for the past forty years have consistently recognized that one who interprets the federal securities laws narrowly in his favor to avoid compliance does so at his peril.[20] Given that judicial history, any party relying on an exculpative non-judicial

---

[18] UMIC had clear reason to know by August 17, 1977, long before the LTV transaction herein, that it might well be in violation of federal law in such activities. *See, Letter of the General Counsel*, Commodities Futures Trading Commission, August 17, 1977, CCH Commodities Futures L.Rep. Paragraph 20, 467, (App. E-1), in which the GNMA Dealers Association (of which UMIC was a member) had sought the general counsel's opinion on legality of the type of trading involved herein. The general counsel first advised that these activities involved securities and commodities and were covered by federal laws on both, and then went on to point out that "the network of primary dealers that you describe in your letter may come within the Act's definition of a board of trade."

[19] See Report of the Joint Treasury — SEC — Federal Reserve Board of Study of the Government-Related Securities Market, (App. D-1 *et seq.*).

[20] As more fully set forth herein, there was no existing statutory or case law upon which UMIC could have found real comfort that its activities were exempt from the federal securities laws. To the contrary, UMIC's activities

interpretation of the definition of a "security" cannot have been totally unaware of the inherent risk in such interpretation. To bootstrap a decision on non-retroactivity on "surprise" or "manifest injustice" to UMIC is ludicrous in this factual and legal context.

Finally, LTV asserts that the underlying issue in this case *is* of "great national concern." Certainly the Congress, the NCUA, the SEC and the nation's financial markets were of that opinion. Since 1933, federal regulation of securities has been a major factor in national commerce. The very existence of a private right of action under the federal securities laws and Rule 10b-5 in particular, recognizes that the SEC cannot possibly, by itself, promptly identify and attack every financial scheme which violates the federal securities laws. Many of the historic developments in securities regulation have resulted from suits by a private party attacking a "private contractual obligation" that it entered.[21] Quite often, numerous of such landmark decisions and statutory changes resulted from what could have been characterized as "a common, routine cause of action — breach of contract" between private litigants, as the Court of Appeals characterizes this case. *See, Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 95 S.Ct. 1917 (1975). Such benign characterization *does not lead* to the conclusion that the issue is not of "great national concern." Private parties have acted as "private attorneys general" for decades in shaping securities regulation on a national basis. The Court of Appeals has

---

were, at the time of the LTV contract, under scrutiny by regulators attempting to determine if, as so many had been in the past, the pattern followed by UMIC was a scheme designed to capitalize on an arguably colorable but untested and invalid statutory interpretation of the federal securities laws. If courts refused to apply changes in existing statutes retroactively because one party *could* have relied on *its own* interpretation of existing statutes, the anomalous result would be to sanction widespread unlawful activities occurring while the parties sought definitive statutory interpretation for several years in the courts.

[21] See, e.g. *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa., 1946). (the first private right of action was under 10b-5)

misconstrued the exception in *Thorpe* and *Bradley* for "manifest injustice." The "manifest injustice" in this case would result from *failure* to apply the statute retroactively. Allowing the opinion of the Court of Appeals to stand as rendered would legitimize the activities of entities like UMIC for the period to the effective date of the Congressional Amendments without any final judicial determination that such activity was in fact legitimate. It would mean every promoter could rely without peril on questionable interpretations of the federal securities laws and other statutes until this Court interpreted them or the legislature changed them despite existing administrative interpretations. If there ever was a statute that this Court should definitively state *must be* applied retroactively, it is this statute as to do otherwise would leave no remedy to those parties who were unlawfully sold these "securities" prior to the Congressional Amendments.

THE OPINION OF THE CIRCUIT COURT ERRONEOUSLY INTERPRETS THE DEFINITION OF AN "EXCHANGE"

The District Court's opinion (adopted by the Court of Appeals) is the first interpretation of the Securities Exchange Act definition of the term "exchange." 15 U.S.C. Sec. 78c(a)(1)[22] That opinion has completely emasculated the definition and straightforward criteria set forth therein. The elements of an "exchange" are: any organization which maintains or provides a marketplace or facility for bringing together purchasers and sellers of securities; or performs functions commonly performed by a stock exchange as that term is generally understood. UMIC employed approximately 100 salesmen in its offices located in five states; in addition to traders, clerical personnel, administrators and officers. The salesmen operated in the part of the facilities referred to as the "brokerage floor." In the Memphis office that was a large room which contained some 50

[22] App. F-29.

salesmen, all with desks and telephones and several traders. Blackboards were posted by the floor traders with current listings of securities either offered for sale or purchase. It was the salesman's job to move these securities by getting on the telephone and finding purchasers or sellers for these securities. The UMIC salesman who solicited LTV's participation in the transactions in question worked in the Houston office with 25 to 30 other UMIC salesmen. In describing these activities he stated that UMIC "made a market" by "bringing buyers and sellers together." According to UMIC's CEO none of these transactions were ever effected through a recognized exchange. UMIC performed all of the functions necessary for their business directly through the Memphis office or through agents. UMIC has never been registered as an exchange, nor has it ever been a member of any stock exchange or board of trade.

Under these facts it is clear that UMIC *was an exchange. In fact, it is admitted that they brought buyers and sellers* together for the purpose of making a market for securities.

It is not persuasive to contend that the application of this statute would make every securities dealer an "exchange" and therefore disrupt the market. The facts are that most recognized securities dealers are members of registered exchanges and conduct their business using such instrumentalities and *are subject to the rules of such exchanges*. They are therefore by the application of other laws not required to register as an exchange. That UMIC chose not to do so is not a defense. The LTV Standby was a contract made in violation of this section. As such it is void. 15 U.S.C. Section 78cc.

The District Court engrafted the agent — principal test into the statutory definition of "exchange."[23] The court has ignored

[23] The District Court stated: "The gist of LTV's argument is that UMIC is an "exchange" because it sometimes matches sales with purchases. That is, a customer of UMIC will inform UMIC that he is interested in purchasing certain securities. If UMIC does not have the securities on hand, it may seek out a seller from whom it can purchase the securities for resale. Conversely, when a potential seller offers to sell his securities, UMIC may first determine

its own admonition to look at the economic realities. By the simple fiction of making out two trade slips instead of one UMIC was permitted to dispense with compliance with the very statutes and regulations designed to protect just such "customers" as LTV. The record shows that UMIC had violated every exchange rule from "know your customer" to "minimum capital requirements." The District Court's opinion will create the framework by which all future cases under Section 78cc will be measured. It is not in keeping with holdings of this Court which employ a flexible approach, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek to profit at the expense of others by constantly avoiding what they perceive as the letter of the law in order to violate its spirit. *SEC v. Howey*, 328 U.S. 293, 84 S.Ct. 1100 (1963).

THE OPINION OF THE COURT OF APPEALS WILL CREATE UNCERTAINTY AS TO THE STATUTORY AND REGULATORY CONTROL OF INVESTMENTS BY FEDERAL CREDIT UNIONS

This is the first reported case to construe the statutory investment powers of federal credit unions, a matter of significance extending beyond the interest of the parties to this case. In adopting the District Court's opinion the Court of

---

whether it has a purchaser before it buys the securities for resale. During a typical day or week, many such requests to buy or sell may be communicated to UMIC, which can then match offers to sell with offers to buy. This, LTV contends, constitutes the operation of an "exchange."

But the fact of the matter is that UMIC purchases and sells securities for its own account, albeit for eventual resale. As with any merchant of any commodity, it may choose not to make purchases until it has lined up customers, or make sales until it has found a source of supply. But that does not mean that UMIC is a marketplace or an exchange. Neither UMIC nor its salesmen — the "brokers" in LTV's scenario — are agents of those who purchase their securities from or sell their securities to UMIC; nor does UMIC owe its customers the fiduciary duties associated with an agent. UMIC buys securities as cheaply as it can, and sells them at the highest possible price, making its profit off the difference." 523 F. Supp. at 834 (App. B-42).

Appeals has created a rule of case law diametrically opposed to the apparent intent of Congress and the administrative agency charged with supervising federal credit unions.

Congress has for years recognized that federal credit unions are run by the members who are not sophisticated investors; its members would be people of "small means."[24]

Originally the *only* investments permitted to be made by federal credit unions were loans to members and investments in obligations of the United States or securities fully guaranteed thereby as to principal and interest thereon. In the 25 times Section 1757 of the Federal Credit Union Act (Powers), 12 U.S.C. Section 1757, has been amended since 1934 the investment authority of federal credit unions is still virtually limited to direct investment in U.S. government and agency securities.[25] Even these are specifically enumerated in 12 U.S.C. Section 1757(7). The investments permitted are "blue ribbon" and virtually risk-free as to payment of principal and interest. The enumeration of each specific type of investment by Congress implies the exclusion of *any others*.[26]

While LTV was permitted to invest directly in GNMA's, Standby commitments are not expressly enumerated.[27] No case found has implied that any non-enumerated investment may be included within terms of Subsection 1757(7).

---

[24] Remarks of Sen. Sheppard, Congressional Record — Senate 1934, p. 7259, 7261.

[25] Statement of NCUA, 43 Fed. Reg. No. 201, page 47731. (App. F-63)

[26] See Texas & Pac. Ry. Co. v. Pottoff, 291 U.S. 245 at 253, 54 S.Ct. 416 at 417, (1934) ". . . the act under which national banks are organized constitutes a complete system for their government. . . . The measure of their powers is the statutory grant; and powers not conferred by Congress are denied."

[27] "(7) to invest its funds . . . in obligations, participations, or other instruments of or issued by, or fully guaranteed as to principal and interest by, . . . the Government National Mortgage Association. . . ." 12 U.S.C. Section 1757(7) (App. F-11, 12).

The opinion of the District Court below premises its holding in deference to the prior interpretations of the NCUA. (523 F.Supp. at page 826. App. B-20 to 24). It then, however, fails to properly identify and utilize these official interpretations.

The NCUA had not expressed any clear and unequivocal opinion with respect to standby commitments at the time of the LTV Standby. However, its position was clearly spelled out to the annual convention of Federal Credit Unions in August 1978 by the Administrator of NCUA: "Standby contracts or other like commitments are in essence put options — futures — and thus separate securities from the underlying lawful securities and are unlawful for credit unions —." Shortly thereafter, in October 1978, proposed rules were published prohibiting just such Standby transactions.[28]

As pointed out by the NCUA such standby option contracts were not authorized by the statute even before they were specifically prohibited in October 1978.[29] In accompanying comments, the NCUA detailed numerous abuses of broker/dealers pointing out that credit unions relying on the expertise of such broker/dealers have suffered heavy losses resulting from speculation in a very volatile market and may present a potential loss to the National Credit Union Share Insurance Fund."[30]

---

[28] "The Administration believes that in a standby commitment one party purchases an option to sell and deliver the securities at a future date. The other party creates the option by agreeing to 'standby' to purchase the securities if the first party elects to sell. *Thus, the investment powers of Federal credit unions (see, 12 U.S.C. 1757(7)) do not include the authority to purchase or sell such an option.* This conclusion is specifically set forth at 12 C.F.R. 703.3(b)(2), which provides that Federal credit unions may not enter into standby commitments to purchase or sell securities." (emphasis added) Federal Register, Vol. 43, No. 201 — Tuesday, October 17, 1978, pp. 47731-32. (App. F-63, 64).

[29] "A Federal credit union may not enter into a standby commitment to purchase or sell a security." 12 CFR 703.3(a)(2).

[30] 43 Fed. Reg. 201 at pages 47731-32. (App. F-63, 64).

The NCUA obviously did not consider these regulations a new addition to existing law, but rather a concise statement of the meaning of the statute and a clear prohibition against investment in standby commitments. The Court of Appeals merely adopted the District Court's opinion holding that LTV had the statutory authority to enter into the LTV Standby. The opinions below state that the NCUA's new rule was expressly not retroactive. That position results from a misapprehension of the NCUA's statement.[31] The very first time that the NCUA proposed a regulation on this question, it clearly stated *"the investment powers of federal credit unions (see 12 U.S.C. 1757(7)), do not include the authority to purchase or sell such an option."* This regulation was the first official administrative pronouncement on the subject. The same inappropriate application was rejected by this Court in *Manhattan General Equipment Co. v. Commissioner of Internal Revenue*, 297 U.S. 129, 56 S.Ct. 397 (1936).[32] The holding in this case has already produced disastrous

[31] The District Court fails to distinguish between the enumerated transactions that were declared to be "not authorized under this Act or constitute unsafe and unusual practices as explained below." 43 Fed. Reg. 201, p. 47731. (App. F-63). It is clear that the NCUA did not intend to legalize "unauthorized" transactions but simply stated that as to the "unsafe and unsound" transactions that the NCUA would not apply any retroactive administrative sanctions, if the credit unions "begin to wind down those activities in a safe and orderly manner." 44 Fed. Reg. 141, page 42676.

[32] "The power of an administrative officer or board to adminster a federal statute and to prescribe rules and regulations to that end is not the power to make law, for no such power can be delegated by Congress, but the power to adopt regulations to carry into effect the will of Congress as expressed by the statute. A regulation which does not do this, but operates to create a rule out of harmony with the statute, is a mere nullity. [citations omitted]

"The contention that the new regulation is retroactive is without merit. Since the original regulation could not be applied, the amended regulation in effect became the primary and controlling rule in respect of the situation presented. It pointed the way, for the first time, for correctly applying the antecedent statute to a situation which arose under the statute." 297 U.S. at 134, 56 S. Ct. at 400.

results not only has it cost the members of the LTV Federal Credit Union over $1,700,000, but it will be cited against other federal credit unions whose cases are just now winding their way up through the courts. In addition, it virtually destroys any hope that some of the losses incurred by the abuses and pure speculations as discovered by the NCUA can be recovered under the "faithful performance bonds" used by federal credit unions to cover the actions of their managers (the only paid officer or director).

Further it allows the unscrupulous brokers and dealers to escape with their ill gotten profits.[33] Even though the statute was there to provide the protection, the courts below refused to enforce it.

Petitioners would urge that the issue of retroactive application of the NCUA regulation, 12 C.F.R. 703.3(a)(2) was improperly decided as the Court of Appeals ignored the general presumption of retroactive application of regulatory changes.[34]

---

[33] This was clearly recognized by the NCUA:

"This Administration believes that some brokers and dealers are not using forwards as they were originally intended, but rather as a means of increasing their own profits and commissions at the expense of their customers . . .

"Additionally, it appears that brokerage firms which deal in government securities have taken little or no action to police their members . . .

"The Administration cannot foresee when and if the abuses in the forwards market will be corrected. *Therefore, the Administration proposes to prohibit Federal credit unions from engaging in the two types of forwards because the transactions are either not authorized under the Act or constitute unsafe and unsound practices as explained below.*" (emphasis added) Federal Register, Vol. 43, No. 201 — Tuesday, October 17, 1978. (App. F-64).

[34] See argument and authorities, pages 15 to 20, *supra*.

CONCLUSION

The opinions of the courts below involve the initial construction of two significant federal statutes and determines the application of new amendments to the definition of a "security." In addition the opinions of the courts below cast serious doubt on the significance of this Court's recent action in the disposition of the *Board of Trade* case, a matter which involves substantial national interest.

The Court of Appeals has erroneously decided important questions of federal law which should be reviewed and settled by this Court.

Petitioner respectfully requests that a writ of certiorari issue to review the judgment of the Court of Appeals for the Fifth Circuit.

Respectfully submitted,

JIM K. CHOATE,
Counsel of Record

JOHN P. LILLY

BRICE AND BARRON,
A Professional Corporation
Suite 3858, 2001 Bryan Tower
Dallas, Texas 75201
(214) 748-6412

Attorneys for Petitioner

DATED: August 4, 1983

83-183

No. 83-

IN THE

Supreme Court of the United States

OCTOBER TERM, 1983

LTV FEDERAL CREDIT UNION,
Petitioner

v.

UMIC GOVERNMENT SECURITIES, INC., and
BANCO DE LA NACION ARGENTINA,
Respondents

APPENDIX TO PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT (FIFTH CIRCUIT NO. 81-1533)

JIM K. CHOATE
Counsel of Record

JOHN P. LILLY

BRICE AND BARRON,
a Professional Corporation
Suite 3858, 2001 Bryan Tower
Dallas, Texas 75201
(214) 748-6412

ATTORNEYS FOR PETITIONER

TABLE OF CONTENTS TO APPENDIX

TABLE OF CONTENTS (Continued)

Page

**LTV FEDERAL CREDIT UNION,
Plaintiff-Appellant,**

v.

UMIC GOVERNMENT SECURITIES, INC. and Banco De La Nacion Argentina, Defendants-Appellees.

UMIC GOVERNMENT SECURITIES, INC. and Banco De La Nacion Argentina, Plaintiffs,

v.

**LTV FEDERAL CREDIT UNION,
Defendant.**

No. 81-1533.

United States Court of Appeals,
Fifth Circuit.

May 6, 1983.

Appeal was taken from a judgment of the United States District Court for the Northern District of Texas, Patrick E. Higginbotham, J., 523 F.Supp. 819, finding seller under standby forward contract liable in damages for breach of contract. The Court of Appeals held that amendments to securities acts to include, inter alia, options on securities within definition of a "security" were not retroactively applicable to standby forward contract entered into between two private parties who were seeking personal

profit in private marketplace; retroactive application would have given seller a seemingly insubstantial right while subjecting purchaser to unforeseen, disastrous consequences which it could and undoubtedly would have avoided had such obligation been apparent.

Affirmed.

Securities Regulation ⟹2

Amendments to securities acts to include, inter alia, options on securities within definition of "security" were not retroactively applicable to standby forward contract entered into between two private parties who were seeking personal profit in private marketplace; retroactive application would have given seller seemingly insubstantial right while subjecting purchaser to unforeseen, disastrous consequences which it could and undoubtedly would have avoided had such obligation been apparent. Securities Act of 1933, § 2(1), 15 U.S.C.A. § 77b(1); Securities Exchange Act of 1934, §§ 3(a)(10), 9, 28(a), 15 U.S.C.A. §§ 78c(a)(10), 78i, 78bb(a); Securities Investor Protection Act of 1970, § 16(14), 15 U.S.C.A. § 78*lll* (14); Investment Company Act of 1940, § 2(a)(18, 36), 15 U.S.C.A. § 80a–2(a)(18, 36).

Jim K. Choate, W.S. Barron, Jr., John P. Lilly, Dallas, Tex., for plaintiff-appellant.

Pettit & Martin, Kerry C. Smith, San Francisco, Cal., Johnson, Swanson & Barbee, Charles R. Haworth, Dallas, Tex., for Banco de la Nacion Argentina.

Martin, Tate, Morrow & Marston, Shepherd D. Tate, W. Thomas Hutton, S. Shepherd Tate, Memphis, Tenn., for UMIC Government Securities, Inc.

Appeal from the United States District Court for the Northern District of Texas.

Before BROWN, GEE and JOLLY, Circuit Judges.

PER CURIAM:

LTV Federal Credit Union (LTV) filed this diversity case as a declaratory judgment action seeking to sanction its unilateral breach of a Standby Commitment Agreement which it had entered two years earlier with UMIC Government Securities, Inc., (UMIC). UMIC in turn sued LTV for breach of contract and securities fraud, and, after complaint was filed, Banco de la Nacion Argentina (Banco) was joined as a plaintiff with UMIC. The cases were consolidated and tried without a jury. The district judge found LTV liable in damages to UMIC and Banco for breach of contract in the aggregate judgment amount of \$1,525,647.91. LTV has filed a timely appeal with this court.

The issues raised in this case are complex, and at first glance, confusing, but the district judge did an admirable job of sorting out and resolving the complexities. The district court's findings are errorless and its conclusions of law comport fully with our conclusions. We therefore adopt Judge Higginbotham's opinion as our opinion on appeal, see *LTV Federal Credit Union v. UMIC Government Securities, Inc.*, 523 F.Supp. 819 (N.D.Tex.1981), with some

slight amplification on one issue. This expansion is occasioned by the passage of legislation after the district court's disposition below.

I.

The contract at issue here is a standby commitment entered into by LTV and UMIC on June 26, 1978. In this type of agreement, a standby forward contract, the seller of the standby agrees to purchase a commodity, here Government National Mortgage Association securities (GNMA's), at some time in the future for a set price, in return for a non-refundable fee from the purchaser of the standby. *See SEC v. G. Weeks Securities,* 678 F.2d 649, 652 (6th Cir.1982).

It is only Judge Higginbotham's finding that the standby commitment was not itself a security subject to registration under section 5 of the Securities Act of 1933, 15 U.S.C. 77e, that we address here. Summarizing this issue, the district court noted:

> From whatever definitional perspective the standby commitment is viewed, the economic reality remains unchanged. LTV did not enter into a common venture with UMIC, or rely on UMIC's financial expertise, or place any capital at risk with UMIC. The parties to the standby commitment did no more than make an option contract to deliver a thing, the value of which is under neither's control. Each took a position on the market in the hope that the market would turn to its advantage and the other's disadvantage. And even if the standby commitment is

considered a 'security' then as a 'stock option' in GNMA's, it is no more subject to registration than the underlying GNMA's. UMIC thus did not violate the Securities Act by failing to register the agreement.

LTV, 523 F.Supp. at 833.

At first glance it is uncertain that LTV has appealed this particular finding. In its statement of issues, LTV lists as issue number five "whether the LTV standby commitment was an unregistered security" under the Texas Securities Act and the 1933 and 1934 Federal Securities Acts, citing the general definitional sections of both the 1933 and 1934 Acts, 15 U.S.C. § 77b and 15 U.S.C. § 78c(a). Its discussion of this issue, however, is devoted almost entirely to the applicability of the Texas Securities Act. Buried within the discussion we do find the following: "It [?] is unregistered and its sale or purchase violated both securities acts. 15 U.S.C. § 77 and 15 U.S.C. § 78." Assuming that this inarticulate statement and the ambiguous "it" refer to the LTV standby commitment (which is not clear in the context), we will address this issue.[1]

II.

Absent congressional action prior to our decision in this appeal, there would be little need for us to write on this or on any other issue presented in this case. Rather, we

1. With respect to our consideration, *infra*, of the equities involved in this issue, we do attach some significance to LTV's indifferent treatment of this issue and the lack of any claim of real prejudice resulting from UMIC's failure to register the standby agreement as a security.

would simply utilize our Rule 21, *see* 5th Cir. R.21; *NLRB v. Amalgamated Clothing Workers of America,* 430 F.2d 966 (5th Cir. 1970), to affirm the district court's findings and conclusions of law. On October 13, 1982, however, one month prior to oral argument in this case, the 1933 and 1934 Securities Acts were amended expressly to include, *inter alia,* options on securities within the definition of a "security." Pub.L. No. 97–303, 96 Stat. 1409 (to be codified at 15 U.S.C. §§ 77b(1), 78c(a)(10), 78i, 78bb(a), 78*lll*(14), 80a–2(a)(18) and –2(a)(36)). This legislation was passed in reaction to a Seventh Circuit case holding that the SEC did not have jurisdiction to regulate options on GNMA securities. *Board of Trade v. Securities and Exchange Commission,* 677 F.2d 1137, 1161 (7th Cir. 1982).

We thus must take into account the Supreme Court's admonition in *Bradley v. Richmond School Board,* 416 U.S. 696, 711, 94 S.Ct. 2006, 2016, 40 L.Ed.2d 476 (1974) that:

> A court is to apply the law in effect at the time it renders its decision, unless doing so would result in manifest injustice or there is statutory direction or legislative history to the contrary.

See also, Payne v. Panama Canal Co., 607 F.2d 155, 163 (5th Cir.1979); *but see, Cox v. Schweiker,* 684 F.2d 310, 318 (5th Cir.1982) (court will normally presume that a legislative enactment is to apply prospectively absent unequivocal statutory directive mandating retroactive application).

In applying this rule, we are also guided by Justice Marshall's frequently cited opin-

ion in *United States v. Schooner Peggy*, 5 U.S. 103, 110, 1 Cranch 103, 110, 2 L.Ed. 49 (1801), which included:

> It is true that in mere private cases between individuals, a court will and ought to struggle hard against a construction which will, by a retrospective operation affect the rights of parties, ...

See, e.g., City of Great Falls v. United States Department of Labor, 673 F.2d 1065, 1068 (9th Cir.1982); *Florida Power and Light Co. v. Costle*, 650 F.2d 579, 590 (5th Cir.1981); *Iowa Power and Light Co. v. Burlington Northern, Inc.*, 647 F.2d 796, 805 (8th Cir.1981).

We therefore set out to determine whether the amendments to the securities laws which are in effect at the time we decide this appeal are to be applied retroactively to the June 26, 1978, transaction in question.

Bradley requires that we apply the October 1982 Securities Acts amendments to this case unless there is statutory direction or legislative history to the contrary, or unless so doing would result in manifest injustice.

A.

We first note that the legislation comprising the amendments makes no mention of an effective date, much less of a directive as to the retroactive or prospective nature of the legislation. The slight one-and-one-quarter-page document simply ends with the following notation: "Approved October 13, 1982." Pub.L. No. 97-303, 96 Stat. 1409.

On the other hand, the legislative history of the bill, embodied in a rather lengthy

House Energy and Commerce Committee report, is laced with such phrases as "*clarification* of SEC jurisdiction", "long-standing Congressional intent that the SEC has the sole authority to regulate options on all securities, including exempted securities," and "confirm the intent of Congress." H.R. Rep. No. 97-626, 97th Cong., 2d Sess. 2, 8, 9, U.S.Code Cong. & Admin.News 1982, pp. 2780, 2786-87. This clarification terminology is not in itself dispositive of the issue before us. *Sikora v. American Can Co.*, 622 F.2d 1116, 1121 (3d Cir.1980) (repeated references to and legislative history concerning Congress's intent to clarify meaning of statute do not justify inference that amendment was to be retroactive).

The issue faced by the Seventh Circuit in *Board of Trade v. SEC*, and the catalyst for the 1982 Securities Act amendments, was which of two regulatory agencies had the authority to regulate trading in GNMA options, since GNMA's are both commodities and securities. *Board of Trade*, 677 F.2d at 1138. Competing for regulatory authority were the securities regulatory body, the SEC, and its commodities regulatory counterpart, the Commodity Futures Trading Commission (CFTC). After searching the legislative history of both the Securities Exchange Act of 1934 and the 1974 amendments to the Commodities Exchange Act which broadened the definition of commodities to include "all other goods and articles, except onions [2] . . . and all services, rights, and interests in which contracts for future

2. That's right, onions.

delivery are presently or in the future dealt in . . . ," *Board of Trade,* 677 F.2d at 1142, the court found that the CFTC rather than the SEC had regulatory authority over the proposed off-set options in GNMA's. 677 F.2d at 1138 and 1153.[3]

. Further, the court stated explicitly that the proposed exchange-formed off-set GNMA options were not securities. *Board of Trade,* 677 F.2d at 1155. Thus, even though the opinion was limited to the specifically proposed off-set options in GNMA's, congressional reaction to the opinion was to extend SEC jurisdiction over all options.

While the exact form of option in *Board of Trade* is not now before us, the Seventh Circuit's discussion of the legislative history of the two regulatory agencies would indicate that, congressional commentary notwithstanding, it was not clear that an option on an exempt security (GNMA's) was

3. The SEC authority to regulate exchange-traded options is found in section 9 of the 1934 Securities Exchange Act, 15 U.S.C. § 78i. That section, however, specifically excludes exempted securities from its provisions. 15 U.S.C. 78i(f). The transaction at issue here is not an exchange-traded option, and it is in fact an option on an exempted security. 15 U.S.C. § 78c(a)(12) (exempted securities under 1934 Securities Exchange Act include those which are direct obligations of or obligations guaranteed as to principal or interest by the United States). Thus the SEC's "plenary options authority" under section 9 did not include options on exempted securities prior to the October 1982 amendments.

itself a security for purposes of registration prior to the 1982 amendments. *Board of Trade,* 677 F.2d at 1159–61.

Supporting this conclusion is *SEC v. G. Weeks Securities,* 678 F.2d 649 (6th Cir. 1982), which specifically noted that a forward standby commitment, at issue here, was not a security. The reasoning of the Sixth Circuit was:

> From a securities law standpoint, the key element in both firm and standby forward contracts is that the only additional risks presented by forward, as opposed to a cash, contract are those of price movement during the executory period. Because prices are determined by competitive market forces, registration of forward contracts could provide no data about the seller which would be relevant to those market risks. The gain or loss stems from the impersonal marketplace alone. It is not the product of a commercial endeavor. Hence, under these circumstances, a forward contract does not meet the law's test of a security subject to registration as "an investment of money in a common enterprise with profits to come solely from the efforts of others."

Weeks, 678 F.2d at 652, citing *SEC v. W.J. Howey Co.,* 328 U.S. 293, 301, 66 S.Ct. 1100, 1104, 90 L.Ed. 1244 (1945).

Reasoning similar to that in *Weeks* was used by then-District Judge Rubin in equating a commodity futures contract with an option. Judge Rubin found that neither met the *Howey* test for an investment contract, *McCurnin v. Kohlmeyer and Co.,* 340 F.Supp. 1338, 1341 (E.D.La.1972), *aff'd per*

curiam, 477 F.2d 113 (5th Cir.1973), a finding approvingly cited in *Moody v. Bache & Co., Inc.*, 570 F.2d 523, 525–26 (5th Cir. 1978).[4]

On the other hand, our research has disclosed no case holding that a standby forward contract in exempt securities, in effect a put option in GNMA's, is itself a security subject to registration under the 1933 Securities Act.

We thus find that the statute provides no guidance as to retroactive or prospective application and that the clarification language used in the committee report, interpreting the intent of previous congresses, does not comport with the reality of the legal uncertainty created by case law, at least as it applies to the transaction at issue. It cannot be said that options on exempt government securities were considered separate securities for purposes of registration prior to the 1982 amendments. We are accordingly unpersuaded that either the statute itself or the legislative history mandates retroactive application of the October 1982 amendments to the standby forward commitment in question here; but neither, and more importantly under the *Bradley* analysis, does the statute or the legislative history direct that the statute be applied prospectively only.

4. A later case in this circuit dealt, in part, with the similar question of whether contracts to sell GNMA securities were exempt from the registration requirements of the 1933 Act. *G.A. Thompson and Co. v. Partridge*, 636 F.2d 945 (5th Cir.1981). The case was decided, however, without reaching this issue. *Partridge*, 636 F.2d at 962–63.

B.

This conclusion therefore brings us to an examination of whether the retroactive application of the securities laws' amendments would result in manifest injustice. Pertinent to this analysis are "(a) the nature and identification of the parties, (b) the nature of their rights, and (c) the nature of the impact of the change in the law upon those rights." *Bradley,* 416 U.S. at 717, 94 S.Ct. at 2019, 40 L.Ed.2d 476; *Central Freight Lines Inc. v. United States,* 669 F.2d 1063, 1069 (5th Cir.1982).

For purposes of defining when retroactive application might work an injustice, *Bradley* distinguishes routine private litigation between individuals from those cases vindicating rights of great national concern. Applicable to this determination is the ability of the parties adequately to present and protect their respective interests. *Bradley,* 416 U.S. at 718, 94 S.Ct. at 2019. In analyzing the nature of the rights, the issue is whether retroactive application would affect rights of the parties which have matured or become unconditional, a status weighing heavily against retroactivity. *Bradley,* 416 U.S. at 720, 94 S.Ct. at 2020. Finally, in determining the impact of the change on existing rights, the inquiry focuses on whether the new law would impose additional and unforeseeable obligations on the parties. *Bradley,* 416 U.S. at 720–21, 94 S.Ct. at 2020–21.

First, the parties to this lawsuit are reasonably sophisticated parties, knowledgeable of financial transactions, who negotiated and entered a single contract. Each had

entered similar contracts with other institutions and corporations, and the court below specifically found that each party to the contract understood the contents of the agreement and the method of its operation. There was no fraud involved in either the inducement or the execution of the agreement; the agreement was a legal contract, a purely private transaction between two private parties. Each party to the agreement hoped to profit from a change in the market, and this litigation sprang from LTV's realization that it would not so profit. Each party has been equally capable of prosecuting its respective claims in this court and the court below.

We thus have two private parties who entered a single, private contract and who are now involved in a routine, private lawsuit stemming from a breach of that negotiated contract. From this perspective, clearly distinguishable from *Bradley* and falling within the ambit of *Schooner Peggy,* we have purely private parties seeking personal profit in the private market place.

We are therefore clearly convinced that the case before us meets the first criterion for the *Bradley* exception—purely private parties engaged in a routine lawsuit who are not vindicating any public right or matter of public interest. It only remains to be determined whether *Gulfshore Oil Co. v. Mobil Oil Corp.,* 453 U.S. 473, 101 S.Ct. 2870, 69 L.Ed.2d 784 (1981), changes the conclusion that we have drawn.

Gulfshore Oil has been cited for the proposition that the importance of the public concerns-private party dichotomy has been diminished. *See, e.g., City of Great Falls v.*

United States Department of Labor, 673 F.2d 1065, 1068 (9th Cir.1982). The basis for this view is the Court's retroactive application in *Gulfshore Oil* of a new statute to a private civil suit where there was no issue of national concern and its statement in footnote 16 that "this equitable exception [manifest injustice] does not reach a private civil suit where the change does not extinguish a cause of action but merely requires a retrial on damages before a properly instructed jury." *Gulfshore Oil,* 453 U.S. at 486 n. 16, 101 S.Ct. at 2879 n. 16. ...

Unlike *Gulfshore Oil,* LTV here seeks, by retroactive application of the statute in question, to negate UMIC's entire cause of action and to escape completely the obligations of the contract that it negotiated and from which it benefitted. In our view these factors serve to distinguish fully the instant situation from that in *Gulfshore Oil.* Concisely, *Gulfshore Oil* does not change our conclusion that an important consideration under the *Bradley* analysis is the private nature and purpose of the parties here.

Second, we turn to the nature of the rights which would be affected by retroactive application of the securities laws' amendments. As with the parties involved, these rights were purely private rights stemming from a privately negotiated contract from which each party hoped to reap personal profit.

These private rights and personal obligations are clearly spelled out in the contract. UMIC was obligated to pay LTV $200,000 in return for the right to sell to LTV $4,000,000 in GNMA securities two years later should UMIC so choose. UMIC paid

LTV the standby fee on July 28, 1978, and twenty months later gave LTV written notice that it would deliver the GNMA's on June 22, 1980, pursuant to the standby commitment. LTV, under the contract, was obligated to purchase the GNMA's on June 22, 1980, upon twenty-days notice from UMIC in return for the right to the $200,000 standby fee.

We thus note that the right which would be affected by retroactive application of the 1982 amendments is UMIC's right to sell the GNMA's to LTV under the contract, a right which fully matured on the date that the contract was entered, June 26, 1978. As *Bradley* noted, "The Court has refused to apply an intervening change to a pending action where it has concluded that to do so would infringe upon or deprive a person of a right that had matured or become unconditional." *Bradley*, 416 U.S. at 720, 94 S.Ct. at 2020.

Third, with respect to the impact that retroactive application of these amendments would have on these existing rights, to find now that the standby commitment is a security which UMIC was obligated to register would not only be to impose an unanticipated obligation on UMIC, *see Bradley*, 416 U.S. at 720–21, 94 S.Ct. at 2020–21, but to question the enforceability of the agreement itself. The impact could not be more devastating upon UMIC's established and matured rights under the contract.

UMIC negotiated a contract and paid $200,000 for the option to sell the GNMA's in question to LTV. It has fulfilled all of its obligations under the contract. The court below, deciding the case before the

amendments were passed, awarded UMIC a $1,500,000 judgment. The retroactive application of the amendments would supposedly reduce that judgment to zero and extinguish every right which UMIC had under the contract. Now to legitimize LTV's breach of the contract by the retroactive application of the October 1982 amendments would be unjustly to enrich LTV while unjustly penalizing UMIC.

On the other hand, the right which LTV here contends that it has lost is the right to have the standby commitment registered. Yet the one circuit which has considered the matter has found that registration of such an agreement would not provide someone in LTV's position with any information relevant to the competitive market forces which determine the price of the contract and thus the risk involved in such an agreement. *See SEC v. G. Weeks Securities,* 678 F.2d 649, 652 (6th Cir.1982). Indeed, as noted *supra* note 1, LTV in its brief to this court failed to claim any real prejudice resulting from UMIC's failure to register the standby agreement as a security.

Thus retroactive application of the 1982 amendments under these circumstances would give LTV a seemingly insubstantial right [5] while subjecting UMIC to unforeseen, disastrous consequences which it

5. We do not intimate here that the registration requirements of the 1933 Securities Act are meritless. On the contrary, they play an important role in the protection of investors and potential investors in securities. Under the circumstances of this case, however, where we are called upon to determine the equity of applying a new law retroactively to the parties in this suit, we must balance the rights that will be obtained by retroactive application against the obligations that will be imposed.

could, and undoubtedly would, have avoided had this obligation been apparent. *Cf. Bradley,* 416 U.S. at 721, 94 S.Ct. at 2021.

Finally we note that the manifest injustice rule is an "equitable exception" to *Bradley's* retroactive application presumption. *Gulfshore Oil,* 453 U.S. at 486 n. 16, 101 S.Ct. at 2879 n. 16. The basis of this litigation is a common, routine cause of action—breach of contract. Two years into the contract and five days before LTV was to purchase the GNMA's, LTV, having decided that it had made a bad bargain, notified UMIC that it would not live up to its part of the agreement—it would not take delivery of or pay for the GNMA securities. Two days after it was to have accepted the GNMA's under the contract, LTV came into federal court armed with a fistful of arguments to justify its contention that the contract was not enforceable. The court below found no fraud involved in the undertaking; rather the contract, which LTV had breached, was an arm's-length transaction between two relatively sophisticated organizations. For all of the reasons stated previously, it is clear that all equitable considerations are on the side of UMIC.

This consideration merely reaffirms our conviction that this case is an exception to the general rule stated in *Bradley* that intervening statutes or case law are to be applied retroactively. Thus, respectful of Justice Marshall's admonition in *Schooner Peggy,* we decline to apply the amendments retroactively to the June 28, 1978, contract between these two private parties. We therefore affirm the district court's holding on this issue, and on all other issues.

AFFIRMED.

LTV FEDERAL CREDIT UNION,
Plaintiff and Counter-Defendant,

v.

UMIC GOVERNMENT SECURITIES, INC., and Banco de la Nacion Argentina, Defendant and Counter-Claimants,

UMIC GOVERNMENT SECURITIES, INC., and Banco de la Nacion Argentina, Plaintiffs,

v.

LTV FEDERAL CREDIT UNION,
Defendant.

Civ. A. Nos. CA-3-80-0795-G,
CA-3-80-1094-G.

United States District Court,
N. D. Texas,
Dallas Division.

Sept. 1, 1981.

Consolidated actions were brought seeking damages, prejudgment interest, and reasonable attorney's fees and costs for federal credit union's alleged breach of standby commitment agreement and seeking declaratory judgment that standby commitment was unenforceable. The District Court, Patrick E. Higginbotham, J., held that: (1) federal credit union had statutory authority to enter into standby commitment; (2) standby commitment agreement was not a

"security" within meaning of federal securities laws; (3) corporation transacting business in government securities did not operate as "exchange" subject to registration requirements of Exchange Act; (4) Texas Blue Sky Act was inapplicable to standby commitment; (5) corporation did not fail to disclose material information to federal credit union by not disclosing standby commitment with Argentinian bank; (6) standby commitment did not violate Tennessee gaming statutes; and (7) corporation was entitled to difference between fair market value of securities on settlement date and unpaid contract price for federal credit union's breach.

Ordered accordingly.

1. Building and Loan Associations ⚩23(4)

General manager of federal credit union had requisite authority to make standby commitment in view of evidence showing that credit union's Board of Directors gave him such authority, adopted investment policy permitting standby commitments, and sent to parent company of corporation with which agreement was made a copy of corporate resolution authorizing general manager to transact securities business on behalf of federal credit union.

2. Building and Loan Associations ⚩23(1)

Even if federal credit union's general manager lacked requisite authority to make standby commitment at time agreement was executed, credit union was estopped by its later conduct from asserting such de-

fense in view of its entering into numerous securities transactions through general manager, including other standby commitments, its Board of Directors' awareness of standby commitment for over a year before breach, and its retention of commitment fee paid with execution of agreements.

3. Building and Loan Associations ⇐2.1

In making policy pursuant to its authority under Federal Credit Union Act, National Credit Union Administration must balance need to protect financial integrity of federal credit unions against need for sufficient investment flexibility for federal credit unions operating in a competitive money market. Federal Credit Union Act, §§ 1 et seq., 107, 12 U.S.C.A. §§ 1751 et seq., 1757.

4. Statutes ⇐219(6)

In construing Federal Credit Union Act, substantial deference must be given to National Credit Union Administration interpretation. Federal Credit Union Act, §§ 1 et seq., 107, 12 U.S.C.A. §§ 1751 et seq., 1757.

5. Building and Loan Associations ⇐24

Given that standby commitment arguably was within literal ambit of Federal Credit Union Act section listing federal credit union's powers, and that National Credit Union Administration construed such section at time of execution of standby commitment as permitting such investment, federal credit union had statutory authority to enter into standby commitment obligating itself to purchase Government National

Mortgage Association Securities. Federal Credit Union Act, §§ 1 et seq., 107, 12 U.S.C.A. §§ 1751 et seq., 1757.

6. Securities Regulation ⚡12, 42

In determining whether a financial instrument is a "security" within meaning of Securities Act, court is not to take literal approach but is to look to economic realities underlying transactions. Securities Act of 1933, § 5, 15 U.S.C.A. § 77e.

7. Securities Regulation ⚡13, 42

Touchstone of whether an instrument is an "investment contract" and thus a "security" within meaning of Securities Act is presence of an investment in a common venture premised on reasonable expectation of profits to be derived from entrepreneurial or managerial efforts of others. Securities Act of 1933, § 5, 15 U.S.C.A. § 77e.

8. Securities Regulation ⚡12, 42

Standby commitment agreement obligating federal credit union to purchase Government National Mortgage Association securities was not a "security" within meaning of federal securities laws. Securities Act of 1933, §§ 2, 2(1), 3, 3(a)(2), 4, 4(2), 5, 15 U.S.C.A. §§ 77b, 77b(1), 77c, 77c(a)(2), 77d, 77d(2), 77e; Securities Exchange Act of 1934, § 3(a)(10), 15 U.S.C.A. § 78c(a)(10).

See publication Words and Phrases for other judicial constructions and definitions.

9. Securities Regulation ⚡13, 42

Standby commitment obligating federal credit union to purchase Government National Mortgage Association securities was not an "investment contract" within meaning of Securities Act or Exchange Act

where there was no "common enterprise," i. e., no common business venture from which both parties could hope to generate profits to be distributed among them, and even if there was any "common enterprise" the profits each party could hope to devise were derived solely from movement of market over which neither had control or ability to influence. Securities Act of 1933, §§ 2, 2(1), 3, 3(a)(2), 4, 4(2), 5, 15 U.S.C.A. §§ 77b, 77b(1), 77c, 77c(a)(2), 77d, 77d(2), 77e; Securities Exchange Act of 1934, § 3(a)(10), 15 U.S.C.A. § 78c(a)(10).

See publication Words and Phrases for other judicial constructions and definitions.

10. Securities Regulation ⇐12, 42

A commodity futures contract or commodities contract for future delivery is not necessarily a "security." Securities Act of 1933, § 5, 15 U.S.C.A. § 77e.

11. Securities Regulation ⇐12, 42

Standby commitment obligating federal credit union to purchase Government National Mortgage Association securities was not "evidence of indebtedness" within meaning of federal securities laws since contemplated exchange of securities for money was not a financial vehicle for returning money loaned to or invested with issuer, i. e., it was not payment for the use of money. Securities Act of 1933, § 5, 15 U.S.C.A. § 77e.

See publication Words and Phrases for other judicial constructions and definitions.

12. Securities Regulation ⇐12, 42

Even assuming that provision of federal securities laws defining as "security" a

"warrant or right to subscribe to or purchase" a security encompassed options to sell, it was inapplicable to standby commitment agreement obligating federal credit union to purchase Government National Mortgage Association securities since agreement could not function as a "security" by its own operation, was not a common enterprise or venture, and exercise of its option did not create interest by investor in common venture organized by issuer of option. Securities Act of 1933, §§ 2(1), 5, 15 U.S.C.A. §§ 77b(1), 77e; Securities Exchange Act of 1934, § 3(a)(10), 15 U.S.C.A. § 78c(a)(10).

13. Securities Regulation ⇐12, 42

A stock option can function as a "security" within meaning of federal securities laws by its own operation. Securities Act of 1933, §§ 2(1), 5, 15 U.S.C.A. §§ 77b(1), 77e; Securities Exchange Act of 1934, § 3(a)(10), 15 U.S.C.A. § 78c(a)(10).

14. Securities Regulation ⇐12, 42

A stock option can function as a "security" within meaning of federal securities laws as an interest in a common venture or enterprise through which investor hopes to profit, even though investor may not have ownership interest until option is exercised, since he has paid money for opportunity to profit from "common enterprise" underlying stock to be delivered, and thus option is merely another financial instrument for providing him with interest in same "common enterprise" underlying stock. Securities Act of 1933, §§ 2(1), 5, 15 U.S.C.A. §§ 77b(1), 77e; Securities Exchange Act of 1934, § 3(a)(10), 15 U.S.C.A. § 78c(a)(10).

15. Securities Regulation ⇐14, 42

Government National Mortgage Association securities are "securities" within meaning of federal securities laws, but are exempt from registration under Securities Act as United States-guaranteed security. Securities Act of 1933, § 3(a)(2), 15 U.S.C.A. § 77c(a)(2).

16. Securities Regulation ⇐14, 42

Congressional determination that common venture underlying Government National Mortgage Association securities, presumably because of guaranteed return, is sufficiently secure that registration under Federal Securities Laws is unnecessary is equally apposite to options to purchase or sell such securities. Securities Act of 1933, § 3(a)(2), 15 U.S.C.A. § 77c(a)(2).

17. Securities Regulation ⇐14

Even if standby commitment obligating federal credit union to purchase Government National Mortgage Association securities was considered a "security" as a stock option in GNMA's, it was no more subject to registration under federal securities laws than underlying GNMA's. Securities Act of 1933, § 3(a)(2), 15 U.S.C.A. § 77c(a)(2).

18. Securities Regulation ⇐12, 42

Because standby commitment obligating federal credit union to purchase Government National Mortgage Association securities was not a "security" within meaning of Exchange Act, corporation with whom federal credit union entered into agreement did not violate Exchange Act by making use of mails to "sell" standby commitment without registering as a broker or dealer. Securities Exchange Act of 1934,

§§ 3(a)(1, 12), 5, 15, 15(a)(1), 15 U.S.C.A. §§ 78c(a)(1, 12), 78e, 78o, 78o(a)(1).

19. Securities Regulation ⇐54

Corporation organized for purpose of transacting business in government securities was not an "exchange" within meaning of Securities Exchange Act, notwithstanding that it sometimes matched sales with purchases, where corporation purchased and sold securities for its own account, albeit for eventual resale, and, as with any merchant of any commodity, it could choose not to make purchases until it had lined up customers or not to make sales until it had found a source of supply. Securities Exchange Act of 1934, § 3(a)(1), 15 U.S.C.A. § 78c(a)(1).

See publication Words and Phrases for other judicial constructions and definitions.

20. Securities Regulation ⇐249

Texas Blue Sky Act was inapplicable to standby commitment obligating federal credit union to purchase Government National Mortgage Association securities since Act exempted sale of any security to any federal credit union. Vernon's Ann.Tex. Civ.St. arts. 581–1 et seq., 581–5, 581–28–1.

21. Securities Regulation ⇐42

Exempted securities are subject to antifraud provisions of federal securities laws, and, specifically, to Rule 10b–5. Securities Exchange Act of 1934, § 3(a)(12), 15 U.S. C.A. § 78c(a)(12).

22. Securities Regulation ⇐119

Even had federal credit union been able to prove misrepresentation regarding

possibility of delivery of Government National Mortgage Association securities by corporation with which credit union entered into standby commitment, it would not have met its burden under antifraud provisions of Securities Exchange Act of showing justifiable reliance where structure of commitment assumed that corporation would deliver securities if it was profitable for it to do so, and would not tender them if such was unprofitable, and alleged representation left unanswered question of why corporation paid credit union commitment fee in first place. Securities Exchange Act of 1934, § 3(a)(12), 15 U.S.C.A. § 78c(a)(12).

23. Securities Regulation ⟹119

Materiality and justifiable reliance are elements of a Rule 10b–5 omissions case. Securities Exchange Act of 1934, § 3(a)(12), 15 U.S.C.A. § 78c(a)(12).

24. Securities Regulation ⟹143

Because of difficulty of proving reliance in an omissions case under antifraud provisions of federal securities laws, reliance may be presumed where plaintiff could justifiably expect that defendants would disclose material information. Securities Exchange Act of 1934, § 3(a)(12), 15 U.S.C.A. § 78c(a)(12).

25. Securities Regulation ⟹63

Corporation's standby commitment with Argentinian bank was not material information required to be disclosed by corporation under antifraud provisions of Exchange Act in entering into standby commitment obligating federal credit union to purchase Government National Mortgage Association securities from corporation since standby commitment with Argentini-

an bank had no bearing on whether corporation would exercise its option to deliver securities to federal credit union, and it was thus not information which a reasonable man would have attached importance to in deciding whether to execute standby commitment. Securities Exchange Act of 1934, § 3(a)(12), 15 U.S.C.A. § 78c(a)(12).

26. Gaming ⇐49(1)

Burden of proving that accused transaction constitutes a gaming contract under Tennessee gaming statutes rests upon party making assertion. T.C.A. §§ 39–2020, 39–2021, 39–2023.

27. Gaming ⇐49(3)

Federal credit union had not met its burden under Tennessee gaming statute of proving that at time of execution of standby commitment either it had no intention of taking delivery of Government National Mortgage Association securities or that corporation transacting business in such securities, with which federal credit union had entered into standby commitment, had no intention of delivering securities, notwithstanding evidence showing that federal credit union's board of directors reviewed its alternatives of whether to take delivery or breach agreement for over a year preceding breach. T.C.A. § 39–2020.

28. Gaming ⇐11

Tennessee gaming statute deeming void contract or agreement for sale of property whereby purchaser is inhibited from making, realizing or receiving more than certain stipulated gain or profit is codification of common-law rule that once a delivery price is fixed by parties, and delivery

made, any later settlement reflecting price fluctuations is gaming. T.C.A. § 39–2021.

29. Gaming ⚩15

Tennessee gaming statute deeming void contract for sale of property whereby purchaser is inhibited from making, realizing or receiving more than certain stipulated gain or profit prohibits contract for future delivery in which buyer agrees to reimburse seller for any increases in market price of delivered security or commodity after delivery. T.C.A. § 39–2021.

30. Gaming ⚩15

Test of Tennessee "bucket shop" gaming statute for determining illegality of transaction is that both parties to contract must have intended to settle on margin without affecting a bona fide buy and sell transaction on a board of trade or exchange; it is not necessary to show that parties did not intend to receive or deliver commodity. T.C.A. § 39–2023.

31. Gaming ⚩14

Federal credit union had failed to show that corporation transacting business in government securities was a "bucket shop" within meaning of Tennessee gaming statute since it had not shown that it was intended between itself and corporation, as parties to standby commitment obligating federal credit union to purchase Government National Mortgage Association securities, that agreement would be settled on difference between contract price and fair market value at time of delivery. T.C.A. § 39–2023.

32. United States ⇔53(9)

Government National Mortgage Association securities are "investment securities" within meaning of Uniform Commercial Code article. T.C.A. § 47–8–102(1).

33. United States ⇔53(9)

Where federal credit union had signed a writing indicating that a contract had been made for sale of stated quantity of Government National Mortgage Association securities at a defined or stated price, such standby commitment was enforceable under Uniform Commercial Code. T.C.A. §§ 47–8–319(a, d).

34. United States ⇔53(9)

Yield maintenance clause in standby commitment agreement obligating federal credit union to purchase Government National Mortgage Association securities did not make price indefinite within contemplation of statute of frauds provision of Uniform Commercial Code investment securities article. T.C.A. § 47–8–319.

35. Corporations ⇔114

Although "investment securities" are expressly excluded from coverage of article of Uniform Commercial Code governing sales, such article may be applied to situation involving "investment securities" not covered by "investment securities" article where such application is sensible. T.C.A. §§ 47–2–101 et seq., 47–2–105 comment, 47–8–101 et seq.

36. United States ⟹53(9)

Corporation transacting business in government securities was entitled to difference between fair market value of Government National Mortgage Association securities on settlement date and unpaid contract price for federal credit union's breach of standby commitment agreement. T.C.A. §§ 47-2-610, 47-2-703, 47-2-708.

37. Interest ⟹35

Letters noticing corporation's intention to deliver Government National Mortgage Association securities to federal credit union pursuant to standby commitment agreement and reiterating corporation's right to deliver such securities bearing coupon rate other than 8.5% created inescapable inference that corporation would deliver 12.5% securities and that federal credit union thus was put on notice of corporation's intention to do so, and thus appropriate coupon rate for measuring corporation's damages upon federal credit union's breach of standby commitment agreement was 12.5%.

38. Interest ⟹39(2)

Under Texas law, award of prejudgment interest is in trial court's equitable discretion.

39. Interest ⟹31, 39(2)

Where federal credit union's breach of standby commitment obligating it to purchase Government National Mortgage Association securities was intentional and made with full knowledge that performance would result in substantial loss, and federal credit union had had opportunity to invest amount it would have expended and origi-

nal commitment fee at interest rates well above 10% per annum, prejudgment interest was proper, and would be awarded at rate of 10% per annum.

Jim K. Choate, Brice & Barron, Dallas, Tex., Kerry C. Smith, Pettit & Martin, San Francisco, Cal., for plaintiff.

Chas. Haworth, Johnson, Swanson & Barbee, Dallas, Tex., for Banco de la Nacion Argentina.

S. Shepherd Tate, W. Thomas Hutton, Shepherd D. Tate, Martin, Tate, Morrow & Marston, Memphis, Tenn., Chas. P. Storey, Francis W. Thayer, Storey, Armstrong, Steger & Martin, Dallas, Tex., for defendants.

MEMORANDUM OPINION

PATRICK E. HIGGINBOTHAM, District Judge.

These consolidated actions arise out of the breach of a standby commitment agreement ("Standby Commitment") between LTV Federal Credit Union ("LTV") and UMIC Government Securities, Inc. ("UMIC"). LTV seeks a declaratory judgment that the Standby Commitment is unenforceable. UMIC and Banco de la Nacion Argentina ("Banco") seek damages of $1,146,250, pre-judgment interest, and their reasonable attorneys' fees and court costs. This Opinion sets forth this court's findings of fact and conclusions of law. Fed.R. Civ.P. 52(a).

I.

On June 26, 1978, LTV, a federal credit union doing business in Texas, and UMIC, a Tennessee corporation organized for the purpose of transacting business in government securities, entered into a contract described as a standby commitment. Under the terms of that agreement, LTV, upon twenty days notice, is obligated to take delivery and pay for on June 22, 1980, $4,000,000 principal amount (plus or minus 2.5%) 8.5% Government National Mortgage Association securities ("GNMA's") at a price of 101% of the principal amount. The Standby Commitment contains what is commonly known as a yield maintenance clause. The clause permits UMIC to deliver GNMA's bearing an interest rate other than 8.5% should the Federal Housing Administration ("FHA") mortgage rate change during the period of the Standby Commitment, provided that the new rate GNMA's are delivered at a price producing an equivalent yield (in this case 8.314%). The Standby Commitment also provides that LTV will maintain a margin, with UMIC having the right to call for additional margin payable within forty-eight hours. In consideration for obligating itself to take delivery of the GNMA's at UMIC's option, LTV receives a $200,000 non-refundable commitment fee. The agreement provides that it shall be construed, and the rights and liabilities of the parties determined, in accordance with Tennessee law.

Contemporaneously with the execution of the Standby Commitment, UMIC entered into a similar agreement with Banco under which UMIC is obligated to take delivery

and pay for on June 22, 1980, $4,000,000 principal amount (plus or minus 2.5%) 8.5% GNMA's at a price of 101% of the principal amount. The terms of the Banco-UMIC standby commitment are identical to those of the UMIC-LTV Standby Commitment, except that Banco must give thirty days notice of its intent to deliver, UMIC receives a commitment fee of $240,000, and no margin is required.

At the time of the execution of the Standby Commitment, LTV assigned to UMIC $250,000 (principal amount) of bonds as margin. On July 28, 1978, UMIC paid LTV the $200,000 non-refundable commitment fee.

During the approximately two year period of the Standby Commitment, the market for GNMA's declined, in large part due to increasing interest rates. FHA mortgage rates fluctuated between 9%, the rate prevailing at the time of the agreement, and 13%; GNMA coupon rates fluctuated between 8.5% and 12.5%. In July of 1980 the prevailing GNMA coupon rate was 11%, with GNMA's available on the market bearing coupon rates of 8.5%, 9%, 9.5%, 10%, 11% and 12.5%.

As interest rates rose, LTV's potential loss under the Standby Commitment increased (as did UMIC's potential loss in its standby commitment with Banco). On April 6, 1979, UMIC called for additional margin, which LTV met by assigning to UMIC $500,000 (principal amount) of bonds. On February 12, 1980, UMIC again requested LTV to post additional margin so as to

bring the total to $1,520,000. LTV denied the margin call, and instead demanded clarification of its obligations under the Standby Commitment. After an exchange of correspondence, UMIC gave written notice by letter dated March 24, 1980, that it would deliver the GNMA's pursuant to the Standby Commitment. On June 17, 1980, LTV informed UMIC that it would not take delivery or pay for the GNMA's. One week later, LTV filed its Complaint seeking a declaratory judgment that the Standby Commitment is unenforceable.

As a result of LTV's breach, UMIC refused to take delivery of the GNMA's tendered by Banco in July of 1980 pursuant to its standby commitment with UMIC. At least initially, UMIC took the position that Banco had failed to provide proper written notice of its election to deliver the GNMA's, and that UMIC, therefore, was not obligated to take the securities. UMIC agreed, however, to accept the Banco GNMA's if LTV would honor its Standby Commitment with UMIC. UMIC and Banco eventually settled their dispute, with UMIC assigning to Banco its rights in this action to the extent of $800,000 plus interest, expenses and attorneys' fees.

II.

LTV raises six grounds in support of its request for declaratory relief:

(1) That T. O. Johnson, LTV's General Manager from 1976 through 1979, did not have the requisite authority to make the Standby Commitment on behalf of LTV.

(2) That LTV did not have the statutory authority in June of 1978 to enter into this type of transaction.

(3) That UMIC violated § 5 of the Securities Act of 1933 ("Securities Act") and Article 581-7 of the Texas Blue Sky Act by dealing in unregistered securities.

(4) That UMIC violated § 5 of the Securities Exchange Act of 1934 ("Exchange Act") and Article 581-12 of the Texas Blue Sky Act by acting as a broker-dealer in connection with the issuance and sale of the Standby Commitment without being registered as either a broker-dealer or an exchange.

(5) That UMIC violated §§ 10(b), 15(a) and 15(c) of the Exchange Act and Rule 10b-5 by: (a) knowingly misrepresenting to LTV that the GNMA's would not be delivered, and (b) knowingly failing to disclose the standby commitment with Banco, and

(6) That the Standby Commitment is an illegal and unenforceable contract under Tennessee gaming statutes.

In addition to its claim for damages under the Standby Commitment, UMIC alleges that LTV violated § 10(b) of the Exchange Act and Rule 10b-5 if LTV and T. O. Johnson, in fact, lacked authority to enter into the Standby Commitment, and that the directors of LTV are individually liable for such fraud as controlling persons within the meaning of the Exchange Act and as aiders and abettors. LTV denies that UMIC has been damaged in the amount claimed.

T. O. Johnson's Authority

[1, 2] The question of Johnson's authority to make the Standby Commitment is relatively straightforward. The evidence shows that LTV's Board of Directors gave LTV's General Manager the requisite authority to enter into these type of transactions; adopted an investment policy permitting standby commitments; and sent to UMIC, Inc. (UMIC's parent) a copy of a corporate resolution authorizing Johnson to transact securities business on behalf of LTV. LTV entered into a number of standby commitments before and after this agreement, and while LTV's Board of Directors may or may not have been aware of this particular standby commitment at the time of its execution, they were aware of Johnson making such investments for LTV. LTV, through Johnson, entered into numerous securities transactions with UMIC and UMIC, Inc., including other standby commitments, but never suggested before this suit that Johnson lacked authority to transact such business. Moreover, LTV's Board of Directors was aware of the Standby Commitment for over a year before the breach, yet remained silent as to Johnson's lack of authority; all the time, of course, retaining the $200,000 commitment fee paid to LTV. LTV thus "played the market" for a year, only denying Johnson's authority once it became evident that the market had turned against it—a risk it had been paid $200,000 to take. This court finds that Johnson had the requisite authority to make the Standby Commitment, and, alternatively, if he lacked such authority at the time the agreement was executed, LTV is es-

topped by its later conduct from asserting the defense. *See generally Restatement (Second) of Agency* § 103 (1958).

LTV's Authority

LTV contends that at the time it entered into the Standby Commitment it had no authority to do so under the Federal Credit Union Act, 12 U.S.C. §§ 1751 *et seq.*, and that it, therefore, cannot be bound by the agreement.

As a federal credit union, LTV's powers are limited by federal statute; specifically, by 12 U.S.C. § 1757. That section provides in pertinent part:

> A federal credit union . . . shall have power—
>
> (1) to make contracts;
>
> * * * * * *
>
> (7) to invest its funds . . . in obligations, participations, or other instruments of or issued by, or fully guaranteed as to principal and interest by, . . . the Government National Mortgage Association . . .;
>
> * * * * * *
>
> (15) to exercise such incidental powers as shall be necessary or requisite to enable it to carry on effectively the business for which it is incorporated.

UMIC contends that because LTV was expressly authorized to invest in GNMA's, it had the power under paragraphs (1) and (15) of § 1757 to purchase GNMA's through standby commitments. LTV argues that it was without authority to enter into the Standby Commitment because § 1757 does not *specifically* identify such agreements as permissible investments.

Any judicial construction of § 1757 must account for the interpretations of the statute made by the National Credit Union Administration ("NCUA"), the federal agency charged with prescribing rules and regulations for the administration of the Federal Credit Union Act. 12 U.S.C. § 1766(a). The parties have stipulated that at the time the Standby Commitment was executed, the NCUA "interpreted the Federal Credit Union Act as authorizing Federal Credit Unions, such as LTV Credit Union, to enter into and consummate GNMA standby commitments." In 1979, however, apparently as a result of volatile interest rates and speculative conduct by some federal credit unions, the NCUA promulgated a regulation prohibiting federal credit unions from entering into standby commitments to purchase or sell securities. *See* 12 C.F.R. § 703.3(b)(2). At the time it issued the final rule, the NCUA cautioned that the rule "is not retroactive and, therefore, does not affect transactions entered into prior to the effective date [July 20, 1979]." 44 *Fed. Reg.* 42,676 (July 20, 1979). Federal credit unions that had made standby commitments were informed that they should meet their commitments, and "begin to wind-down those activities in a safe and orderly manner." *Id.*

The Federal Credit Union Act gives the NCUA broad regulatory authority over federal credit unions. The NCUA is charged with supervising the financial soundness of federal credit unions, and each federal credit union is required to submit annual financial reports to the NCUA as well as open its

books and records to NCUA inspection. 12 U.S.C. § 1756. The NCUA may suspend or revoke the charter of any federal credit union, or place the credit union in involuntary liquidation, upon finding that the credit union has violated any provision of the Federal Credit Union Act or any NCUA regulation issued thereunder. 12 U.S.C. § 1766(b)(1).

[3, 4] In making policy pursuant to its authority, the NCUA must balance the need to protect the financial integrity of federal credit unions against the need for sufficient investment flexibility for federal credit unions operating in a competitive money market. Because the NCUA operates in a dynamic environment of evolving investment instruments, regulatory prescience almost is required. Investments which initially appear reasonable and safe, may, under changed economic conditions, and with the benefit of experience, later be found speculative and unsound. It is not surprising that Congress has given the NCUA broad regulatory latitude. Accordingly, in construing the Federal Credit Union Act, substantial deference must be given to NCUA interpretation.

As with most regulatory schemes, Congress has provided a skeleton to be "fleshed out" over time. Although some of the powers listed in § 1757 are set forth in detail, others beg clarification.[1] Ambiguities are

1. *See, e. g.*, § 1757(1) (power to make contracts), (4) (power to purchase, hold and dispose of property), (15) (power to exercise incidental powers).

inevitable, and a source of easily accessible authoritative statutory interpretation is necessary if federal credit unions are not to operate under a very real threat of potential lawsuits for *ultra vires* activity. Not only would a contrary policy inhibit federal credit unions from making investments that may be entirely consistent with the spirit of the Federal Credit Union Act, but federal credit unions most likely would find an understandable reluctance by other financial institutions to transact business with them. Finally, given the sanctions the NCUA may take against a federal credit union *which the NCUA finds* to have violated the Federal Credit Union Act, *see* 12 U.S.C. § 1766(b)(1), it is unrealistic to assume, as LTV now contends, that the NCUA's construction of the Act at the time of the execution of the Standby Commitment does not warrant judicial deference.

[5] Under a literal interpretation of § 1757, LTV appears to have had the power to enter into standby commitments to purchase GNMA's. Section 1757(1) authorizes federal credit unions to make contracts, and § 1757(7)(E) authorizes the purchase of GNMA's. As UMIC notes, LTV here simply obligated itself to purchase GNMA's. The section, of course, is silent on whether such a contract may be in the form of a standby commitment or any other arrangement permitting future delivery.[2] But giv-

2. It is unlikely that Congress had the opportunity to consider this type of transaction in granting the § 1757(7)(E) powers. The provision permitting the purchase of GNMA's was added in 1968, Pub.L. 90–448, while a standby commitment to purchase GNMA's is a relatively recent financial phenomenon.

en that the Standby Commitment arguably is within the literal ambit of § 1757, and that the NCUA at the time construed § 1757 as permitting such an investment, this court holds, consistent with the deference due the NCUA, that LTV had the statutory authority to enter into the Standby Commitment.[3]

3. The power of federal credit unions "to make contracts" obviously necessitates more detailed definition if the NCUA is to regulate the type of investments made by federal credit unions. The NCUA appears to proceed on the assumption, and one this court has no cause to disagree with, that the NCUA has the authority to determine the type of contracts permissible under the Federal Credit Union Act. For example, 12 C.F.R. § 703.3 lists a number of investment transactions, prohibiting some altogether, while conditioning others. LTV's facile argument that because the language of the Federal Credit Union Act remains unchanged, the NCUA's determination of permissible investments must be applied retroactively, disregards the legal and financial havoc such a holding would cause. Federal credit unions which have made investments believing themselves empowered to do so, could find themselves facing liability to other contracting parties if later NCUA policy pronouncements retroactively eliminate the requisite authority. Directors of the credit unions presumably would be liable to their members for any losses incurred in such transactions. And the NCUA, in all likelihood, would be inhibited from issuing its interpretations for fear of exposing federal credit unions and individual directors to substantial liability. Absent express statutory language to the contrary, this court is unwilling to hold that NCUA policy statements permitting certain types of investments are necessarily undermined by later regulations prohibiting the same investments.

Registration Under the Securities Act

LTV contends that the Standby Commitment is a "security" within the meaning of the Securities Act, and, therefore, subject to registration. Because the Standby Commitment is not registered pursuant to § 5 of the Securities Act, 15 U.S.C. § 77e, LTV argues the agreement is void and unenforceable. UMIC responds that the Standby Commitment is not a "security," as defined by § 2 of the Act, 15 U.S.C. § 77b(1), and, even if it were, it is exempted from registration by § 3, 15 U.S.C. § 77c(a)(2) (exempting securities guaranteed by the United States), and § 4, 15 U.S.C. § 77d(2) (exempting transactions by an issuer not involving any public offering).

The Securities Act provides:

> [U]nless the context otherwise requires—
>
> [t]he term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

15 U.S.C. § 77b(1). The corresponding definition of the Exchange Act, 15 U.S.C.

§ 78c(a)(10), though slightly different, is functionally equivalent. *See Tcherepnin v. Knight*, 389 U.S. 332, 336, 342, 88 S.Ct. 548, 553, 556, 19 L.Ed.2d 564 (1967).

LTV claims that the Standby Commitment is "evidence of indebtedness," an "investment contract," and a "warrant or right to subscribe to or purchase" a security (GNMA's).

[6–8] It is well established that in determining whether a financial instrument is a "security," the court is not to take the "literal approach," but is to look to the economic realities underlying the transaction. *See, e. g., United Housing Foundation, Inc. v. Forman*, 421 U.S. 837, 848–58, 95 S.Ct. 2051, 2058–63, 44 L.Ed.2d 621 (1975); *National Bank of Commerce of Dallas v. All American Assurance Co.*, 583 F.2d 1295, 1300–02 (5th Cir. 1978). The most commonly used analytical vehicle for making that determination has been the "investment contract." The touchstone of whether an instrument is a "investment contract," is "[1] the presence of an investment [2] in a common venture [3] premised on a reasonable expectation of profits [4] to be derived from the entreprenuerial or managerial efforts of others."[4] *United*

4. The standard implies a certain commonality of interest between the investor and the issuer. That is, while the issuer may not always have the investor's best interests at heart once he has obtained the investor's money, the investor hopes the issuer will succeed in his business venture, for without some success, there are no profits to distribute. Here, once the Standby

Housing Foundation, Inc. v. Forman, supra, 421 U.S. at 852, 95 S.Ct. at 2060; *United Bank of Nashville v. Gunter,* 620 F.2d 1108, 1114 (5th Cir. 1980). The Court in *Forman* observed that this test "embodies the essential attributes that run through all of the Court's decisions defining a security." 421 U.S. at 852, 95 S.Ct. at 2060. *See Teamsters v. Daniel,* 439 U.S. 551, 558 n.11, 99 S.Ct. 790, 795 n.11, 58 L.Ed.2d 808 (1979) (quoting passage from *Forman*). That statement, naturally enough, has led to speculation that the elements of an "investment contract" are generic to all securities. *See* Deacon & Pendergast, "Defining a 'Security' After the *Forman* Decision," 11 *Pacific L. J.* 213, 217–18 (1980) (*Forman* combined under one definitional standard analysis "investment contract" securities and other types of securities as defined in 15 U.S.C. § 77b(1)); *see also Elson v. Geiger,* 506 F.Supp. 238, 231 (E.D.Mich.1980) ("investment contract" catch-all phrase); 1 Bromberg & Lowenfels, *Securities Fraud & Commodities Fraud,* § 4.6 (314) (1981) ("investment contract" broadest of statutory definitions). The Fifth Circuit, however, recently rejected that proposition, and cautioned against using the standard in a talismanic fashion. *See Meason v. Bank of Miami,* 652 F.2d 542, 547–51 (5th Cir. 1981). The Circuit's apprehensions may be the re-

---

Commitment was made and the commitment fee paid, LTV and UMIC were financial adversaries. Any profit by either party could only come at the expense of the other. Assuming rational profit maximization by both parties, LTV could only benefit from this transaction if things went poorly for UMIC.

sult of a more narrow construction of the "investment contract" test than that suggested in the Supreme Court's decisions.[5] But this court does not reach the issue; for the reasons stated below, whether the Standby Commitment is analyzed under an all embracing "investment contract" test, or under each of the statutory definitions, the

5. The Circuit may be proceeding on the assumption that the "common enterprise" element of the "investment contract" test is not met where the investor is entitled only to a fixed return rather than a percentage of profit. *Meason v. Bank of Miami, supra*, at 547–48. If such is correct, than a corporate note or bond is not an "investment contract," and the Circuit's unwillingness to apply the test across the board certainly is understandable. Arguably implicit in the Supreme Court's decisions, however, is that the existence of "common enterprise" is not dependent on whether the return is fixed. The determinative factor appears to be whether the investment transaction is so structured that the money to pay off the investor eventually will be generated by the venture or enterprise. That the investor may be entitled to a return even if the venture does not generate a profit does not alter the fact that the investment is made on the belief that the venture will succeed. Assuming such is the teaching of the Supreme Court, the differences between the Court and the Circuit appear to be primarily semantic.

Meason nevertheless is representative of the analytical distinction between Supreme Court and many lower court definitions of "security." The Court has been moving toward a generalized concept of "security," in what appears to be an attempt to identify a set of characteristics fundamental to all securities. In so doing, it increasingly has emphasized the economic realities underlying the transaction and deemphasized application of the individual statutory definitions. *See Teamsters v. Daniel, supra*, 439 U.S. at 558 n.11, 99 S.Ct. at 795 n.11. The lower courts, including most of the Circuits,

agreement is not a "security" within the meaning of the federal securities laws.[6]

An investment contract "means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party." *SEC v. W. J. Howey Co.*, 328 U.S. 293, 298–99, 66 S.Ct. 1100, 1102–03, 90 L.Ed. 1244 (1946); *see Williamson v. Tucker*, 645 F.2d 404, 417–19 (5th Cir. 1981) (word "solely" may be excised from *Howey* definition).[7] The obvious question is whether the Standby Commitment is a "common enterprise" from which LTV can "expect profits from the efforts of [UMIC] or a third par-

---

while recognizing the direction of the Court's movement, continue to rely heavily in their analyses on the individual statutory definitions. One result of that approach is the continuing and often contradictory endeavor to define the precise parameters of each definition so as to determine the proper "test" to apply to a given transaction. *Compare, e. g., Meason v. Bank of Miami, supra*, (distinction between "investment notes" and "commercial notes" cannot be derived from "investment contract" test) *with United American Bank of Nashville v. Gunter, supra*, (applying "investment contracts" test to determine boundaries of commercial-investment note dichotomy).

6. Most recently, the Fifth Circuit has withheld decision of the question of whether a contract to sell a GNMA is an "investment contract." *See G. A. Thompson & Co., Inc. v. Partridge*, 636 F.2d 945, 962–63 (5th Cir. 1981).

7. The alternative "risk capital" approach has not been adopted by the Fifth Circuit. *See Martin v. T. V. Tempo, Inc.*, 628 F.2d 887, 891 (5th Cir. 1980).

ty."[8] In *McCurnin v. Kohlmeyer & Co.*, 340 F.Supp. 1338, 1341 (E.D.La.1972) *aff'd per curiam*, 477 F.2d 113 (5th Cir. 1973), then district judge Alvin B. Rubin faced a similar question in the context of commodity future contracts. In rejecting the argument that such contracts are "investment contracts," the court stated:

> A commodity future contract is no more or less than an option; the purchaser agrees to take delivery, or the seller agrees to make delivery, of a specified quantity of a specified commodity at a specified future time at a specified price. Unless the investor reverses his position timely by selling what he has bought or buying what he has sold, he must accept delivery of the commodity and pay the full purchase price as set by the contract (or deliver the commodity against full payment, if he has sold). He is in no way investing his money in a common enterprise, nor is he led to expect profits solely form the efforts of any third party. The "enterprise" is an individual one. The expectation of profit arises solely from the speculative hope that the market price of the underlying commodity will vary in his favor, permitting purchase or sale at a profit.

8. This court assumes, without deciding, that UMIC is the issuer of the Standby Commitment. The assumption may be highly questionable. The SEC, for example, in suggesting that Standby Commitments may be securities, identifies the party receiving the commitment fee as the issuer. *See* "Securities Trading Practices of Registered Investment Companies," 44 *Fed.Reg.* 25,128, 25,131 (April 27, 1979).

Accord, Moody v. Bache & Co., 570 F.2d 523, 525-26 (5th Cir. 1978).[9]

[9] This court here sees no functional distinction between the Standby Commitment and commodity contracts for future delivery, as regarding their possible status as "investment contracts," that would justify a different holding here. The economic realities of this transaction are that there is no "common enterprise"—no common business venture from which both parties can hope to generate profits to be distributed among them. And even if there were a "common enterprise," the profits each party can hope to derive, are derived solely from the movement of a market over which neither has control or the ability to influence. The Standby Commitment thus is not an "investment contract" within the meaning of the Securities Act or the Exchange Act.

[10] An "evidence of indebtedness" has been defined as a "contractual obligation to pay in the future for consideration presently received." *United States v. Austin*, 462 F.2d 724, 736 (10th Cir.), *cert. denied*, 409 U.S. 1048, 93 S.Ct. 518, 34 L.Ed.2d 501 (1972). Applied as literally as LTV urges, this standard makes every option contract a "security," for an option is but an agreement to sell or buy something (commodity,

9. It may be argued that the Standby Commitment is a "discretionary account," as discussed in *Moody*, because UMIC has the discretion to choose the coupon rate it will deliver. To the extent that UMIC has discretion, it is the discretion to determine the extent of *its* profits and *LTV's losses*. In reality, however, there is no real discretion because UMIC always delivers the available coupon rate giving *it* maximum profit.

security or foreign currency) in the future, at a fixed price, for consideration presently received or paid. It is well established, however, that a commodity futures contract or commodities contract for future delivery is not necessarily a security. *See supra*; 1 Bromberg & Lowenfels, *supra*, note 6, § 4.6 (414); *cf., Glazer v. National Commodity Research & Statistical Service, Inc.*, 547 F.2d 392, 393 (7th Cir. 1977) (rejecting SEC argument that options to buy or sell commodities futures are "evidence of indebtedness").

In *United States v. Jones*, 450 F.2d 523, 525 (5th Cir. 1971), the court held that the "term 'evidence of indebtedness' embraces only such documents as promissory notes which on their face establish a primary obligation to pay the holders thereof a sum of money." Because *Jones*, like *Austin*, construes 18 U.S.C. § 2311, its precedential authority as to Securities Act cases is uncertain. But *Jones* points to a logical distinction—that is, that the term "evidence of indebtedness" contemplates a payment of a sum of money in the future for consideration presently received, and not an exchange in the future of securities or commodities for a sum of money.[10] *See also*

10. Besides being inconsistent with *Jones*, a literal construction of *Austin* does not draw any distinction between commercial transactions and investment transactions. If *Austin* is correct that "*all* contractual obligations to pay in the future for consideration presently received" are "evidence of indebtedness," then all commercial notes are securities. *But see Williamson v. Tucker, supra*, at 426–29. Nor are the facts of *Austin* consistent with giving the opinion the broad reading LTV urges. There, the

Barack v. United States, 317 F.2d 619, 623 (9th Cir. 1963). A contrary holding "would be tantamount to a declaration that all bilateral executory contracts are securities under the federal securities laws." *Bergman v. Dean Witter & Co., Inc.*, 353 F.Supp. 669, 671 (C.D.Cal.1973) (rejecting proposition that futures contract for Japanese yen is "evidence of indebtedness").

[11] That distinction is consistent with *SEC v. G. Weeks Securities, Inc.*, 483 F.Supp. 1239 (W.D.Tenn.1980), in which the court held that a "standby with pair-off," as operated, was "evidence of indebtedness."[11] There, no GNMA's were actually delivered—there was no exchange of bonds for money. The transaction in *Weeks* was a book transfer of GNMA's, with the only real risk to investors being the inability of the issuer to invest the commitment fees profitably enough to meet the "interest" payments. *See* note 11. But here, as in *Bache Halsey Stuart v. Affiliated Mortgage Investments, Inc.*, 445 F.Supp. 644 (N.D.Ga. 1977), there is no guaranteed profit for UMIC (or LTV). *See* 483 F.Supp. at 1244 n.6. In other words, the exchange of

---

defendant-issuer made a standby commitment *to guarantee a loan*, in return for which he received a commitment fee. There was no exchange of a security or commodity for money similar to the transaction here.

11. A "standby with pair-off" is a different transaction from a standby commitment. The investor in such a transaction pays a commitment fee for the right to buy a bond at a fixed price a certain number of days hence and, at his option, simultaneously sell it back at a higher fixed price (he instead may keep the bond and sell it on the market). The difference between these prices exceeds the commitment

GNMA's for money contemplated by the Standby Commitment is not a financial vehicle for returning money loaned to or invested with the issuer (or, more correctly put, since LTV claims to be the investor, loaned to or invested with the investor)—it is not payment for the use of money. *See also SEC v. Commodity Options International, Inc.*, 553 F.2d 628 (9th Cir. 1977) (naked double option pure facade for investment). The Standby Commitment thus is not "evidence of indebtedness" within the meaning of the federal securities laws.

[12] LTV contends that even if the Standby Commitment is not an "investment contract" or an "evidence of indebtedness," it should be considered a security because it is a "warrant or right to subscribe to or purchase" a security (GNMA's). 15 U.S.C. §§ 77b(1), 78c(a)(10). An obvious obstacle for LTV is that the Standby Commitment is not an option to "subscribe to or purchase" anything; at best, it is an option to sell. *See generally* 15 U.S.C. § 78c(a)(13), (14) (defining terms "buy," "purchase," "sale" and "sell"). But even assuming that the provision encompasses options to sell, it is inapplicable to the Standby Commitment.

---

fee by an amount referred to as "interest." The investor is "guaranteed" a profit (the "interest") with theoretical further upside potential. The issuer makes his money by investing the paid-in commitment fee between the time he receives it and the time the bond theoretically is delivered. But unless the issuer's investment efforts are successful, the investor does not receive his profit. The economic reality of the transaction is that the investor makes his money off the "interest." He, in effect, loans money to the issuer for a "guaranteed" return—a return dependent upon the issuer's skills.

[13] As the Supreme Court noted in the context of the definitional category of "any . . . stock," a court must look beyond the label placed upon an instrument to the economic purpose of the instrument or transaction. *See United Housing Foundation, Inc. v. Forman, supra,* 421 U.S. at 848–51, 95 S.Ct. at 2058–60. A stock option can function as a "security" in two distinct senses. First, it can function as a "security" by its own operation. *See, e. g., Alvord v. Shearson Hayden Stone, Inc.,* 485 F.Supp. 848 (D.Conn.1980) (stock option "trading system" an "investment contract"); *SEC v. G. Weeks Securities, Inc., supra* (GNMA "standby with pair-off" a security); *cf., Moody v. Bache & Co., supra* (discretionary commodities account a security); *SEC v. Commodity Options International, Inc., supra* (naked double commodities option pure facade for "investment contract"). The Standby Commitment is not a "security" in that sense. *See supra,* at pp. 828–831.

[14] The second sense in which a stock option can function as a "security" is as an interest in a common venture or enterprise through which an investor hopes to profit. With the typical stock option, the issuer sells an option in stock he has or will issue. Although the investor may not have an ownership interest until the option is exercised, he has paid money for the opportunity to profit from the "common enterprise" underlying the stock to be delivered. Thus, the typical stock option is merely another financial instrument for providing the investor with an interest in the same "common enterprise" underlying the stock. Accordingly, the typical stock option is a "se-

curity." *See Alvord v. Shearson Hayden Stone, Inc., supra,* at 851 n.3.

The Standby Commitment is not a "security" in that sense either. The agreement is not a common enterprise or venture between LTV and UMIC. Nor does UMIC, by exercising its option, create an interest by a investor (LTV) in a common venture organized by the issuer of the option (UMIC).

[15, 16] LTV argues that the Standby Commitment nevertheless is a "security" because the agreement represents an interest by it in the underlying GNMA's. That is, although the Standby Commitment does not function as a "common enterprise" between LTV and UMIC, it operates as a "common enterprise" between LTV and the original issuer of the GNMA's to be delivered. To the extent that the Standby Commitment can be considered a "security" in that sense, it is plain—even implicit to the argument—that the "common enterprise" underlying the "option-security" is the same "common enterprise" underlying the GNMA's to be delivered.[12] GNMA are se-

12. An analogous observation was made by the Ninth Circuit in *SEC v. Commodity Options International, Inc., supra,* in the context of commodity futures contracts. The court noted that although futures contracts are investments, they are not investments in an enterprise, but in the "underlying commodity." *Id.* at 632. The court then assumed, without deciding the question, "that a conventional option to buy or sell a futures contract takes on the character of the contract that is the option and is no more a security than is the underlying contract." *Id.*

curities, but as United States guaranteed securities, they are exempt from registration under the Securities Act. *See* 15 U.S.C. § 77c(a)(2); *Bache Halsey Stuart, Inc. v. Affiliated Mortgage Investments, Inc., supra.* Congress has determined that the common venture underlying GNMA's, presumably because of the guaranteed return, is sufficiently secure that registration is unnecessary. That determination is equally apposite to options to purchase or sell GNMA's. *See Bache Halsey Stuart, Inc. v. Affiliated Mortgage Investments, Inc., supra; cf.*, note 12, *supra* (option on commodity future contracts takes on character of contract underlying the option). Essentially, this court does not agree that an option to purchase or sell an exempt security, of itself, is sufficiently distinct from the underlying exempt security that the option falls outside the statutory exemption. The GNMA's thus are roughly analogous to commodities, with an option therein no more or less a security than the thing to be delivered. *See* note 12, *supra*; "Letter of SEC Chairman Roderick M. Hills, November 13, 1975, and CFTC staff response, publicly available December 3, 1975," *Fed.Sec.L.Rep.* (CCH) ¶ 80,336 at 85,-

---

The SEC apparently has taken a similar position with regard to contracts for delayed delivery of GNMA's. *See* Note, "The GNMA Securities Market: An Analysis of Proposals for a Regulatory Scheme," 9 *Fordham Urban L. J.* 457, 478 n.112 (1980); *but see* "Securities Trading Practices of Registered Investment Companies," 44 *Fed.Reg.* 25,128, 25,131 (April 27, 1979).

870 n.34 [1975–1976 transfer binder] (CFTC believes GNMA futures exempt from registration). In this regard, it is important to note that the purpose of the registration requirement is "to assure public access to material facts bearing on the value of the publicly traded security." *SEC v. Aaron*, 605 F.2d 612, 618 (2d Cir. 1979), *vacated on other grounds*, 446 U.S. 680, 100 S.Ct. 1945, 64 L.Ed.2d 611 (1980). But the value of the enterprise underlying a stock option is no more than the value of the enterprise underlying the security to be delivered. *Cf.*, *Woods v. Homes and Structures of Pittsburgh, Kansas, Inc.*, 489 F.Supp. 1270, 1293–94 (D.Kan.1980) (guarantee attached to exempt municipal bond not treated differently from bond). LTV, of course, finds itself in the same position as had it made an identical standby agreement with an original issuer of GNMA's.[13]

Such a holding also is consistent with the design of the "warrant or right to subscribe to or purchase" provision of the statutory definition. The provision serves two related purposes. First, it prevents issuers from circumventing registration by using stock options to raise capital.[14] Second, it ensures

13. LTV implies that the registration requirements of § 5 are necessary to protect investors from fraudulent practices by the issuers of such options. But, as discussed *infra*, the registration exemption does not affect the applicability of Rule 10b–5.

14. For example, a corporation could sell options to shares it does not intend to issue for several years. Unless such options are securities, the corporation will have avoided registration, at least until the options are exercised.

that purchasers of stock options will have the same information as those who purchase the stock. Such is desirable, in that purchasers of options are subject to the same marketplace risks and corresponding need for information to which the registration and prospectus requirements of the Securities Act are directed. Neither purpose has any application where the security to be delivered itself is exempt from registration.[15]

[17] In sum, from whatever definitional perspective the Standby Commitment is viewed, the economic reality remains unchanged. LTV did not enter into a common venture with UMIC, or rely on UMIC's financial expertise, or place any capital at risk with UMIC. The parties to the Standby Commitment did no more than make an

15. This court expresses no opinion as to the applicability of its analysis to the type of GNMA futures traded on the Chicago Board of Trade. *See*, Note, "The GNMA Securities Market: An Analysis of the Proposals for a Regulatory Scheme," *supra*, at 463–67; Guttman, "The Futures Trading Act of 1978: The Reaffirmation of CFTC-SEC Coordinated Jurisdiction Over Security/Commodities," 11 *Am.U.L.Rev.* 1, 23 n.130 (1978); *Bache Halsey Stuart v. Affiliated Mortgage Investments, Inc., supra*, at 646.

LTV has made no claim concerning the legality of the Standby Commitment under the Commodity Exchange Act, 7 U.S.C. § 1 *et seq.*, and this court expresses no opinion as to the applicability of the Act. *See SEC v. G. Weeks Securities, Inc., supra*, at 1244–46. Nor does this court express any opinion as to the possible preemptive force of the Commodity Exchange Act with regard to LTV's claims under Rule 10b–5, the Texas Blue Sky Act, and the Tennessee gaming statutes. *See infra*.

option contract to deliver a thing, the value of which is under neither's control. Each took a position on the market in the hope that the market would turn to its advantage and the other's disadvantage. And even if the Standby Commitment is considered a "security" as a stock option in GNMA's, it is no more subject to registration than the underlying GNMA's. UMIC thus did not violate the Securities Act by failing to register the agreement.

Registration Under the Exchange Act

LTV contends that UMIC violated the Exchange Act by acting as a broker-dealer without registering as such. Alternatively, LTV argues that UMIC is an unregistered "exchange."

Section 15 of the Exchange Act provides in pertinent part:

> It shall be unlawful for any broker or dealer . . . to make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of any security (*other than an exempted security* . . .) unless such broker or dealer is registered in action with subsection (b) of this section.

15 U.S.C. § 78*o*(a)(1) (emphasis added).

[18] As noted, the Standby Commitment is not a "security" within the meaning of the Securities Act. There being no functional difference between the definitions of the Securities Act and the Exchange Act, *see Tcherepnin v. Knight, supra*, the Standby Commitment also is not a "security," as

defined by the Exchange Act. In this regard, the Exchange Act classifies United States guaranteed securities as "exempted securities." 15 U.S.C. § 78c(a)(12). Because the Standby Commitment is not a "security," UMIC did not violate the Exchange Act by making use of the mails to "sell" the Standby Commitment without registering as a broker or dealer.

Section 5 of the Exchange Act provides in pertinent part:

> It shall be unlawful for any broker, dealer, or exchange, directly or indirectly, to make use of the mails ... for the purpose of using any facility of an exchange ... to effect any transaction in a security ... unless such exchange ... is registered as a national securities exchange....

15 U.S.C. § 78e.

An "exchange" is defined as:

> any organization, association, or group of persons ... which constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange as that term is generally understood....

15 U.S.C. § 78c(a)(1).

LTV contends that UMIC is an unregistered "exchange," and, by using its own facilities, violated the Exchange Act. UMIC responds that if it is an "exchange," then virtually every stock broker or dealer in the country is in technical violation of the Exchange Act.

[19] This court does not agree that UMIC operates as an "exchange." UMIC does not use its facilities or otherwise provide a marketplace for bringing together purchasers and sellers of securities. Nor does UMIC perform the functions commonly performed by a stock exchange.

The gist of LTV's argument is that UMIC is an "exchange" because it sometimes matches sales with purchases. That is, a customer of UMIC will inform UMIC that he is interested in purchasing certain securities. If UMIC does not have the securities on hand, it may seek out a seller from whom it can purchase the securities for resale. Conversely, when a potential seller offers to sell his securities, UMIC may first determine whether it has a purchaser before it buys the securities for resale. During a typical day or week, many such requests to buy or sell may be communicated to UMIC, which can then match offers to sell with offers to buy. This, LTV contends, constitutes the operation of an "exchange."

But the fact of the matter is that UMIC purchases and sells securities for its own account, albeit for eventual resale. As with any merchant of any commodity, it may choose not to make purchases until it has lined up customers, or make sales until it has found a source of supply. But that does not mean that UMIC is a marketplace or an exchange. Neither UMIC nor its salesmen—the "brokers" in LTV's scenario—are agents of those who purchase their securities from or sell their securities to UMIC; nor does UMIC owe its customers

the fiduciary duties associated with an agent. UMIC buys securities as cheaply as it can, and sells them at the highest possible price, making its profit off the difference.

An "exchange" is a place where or means through which buyers and sellers, or their respective agents, meet to negotiate and consummate purchases. Although a merchant (or dealer) may serve the same ultimate economic purpose by facilitating the efficient reallocation of whatever is sold, there is a fundamental distinction. An "exchange" functions on the principle that if potential buyers and sellers can meet to exchange information, they may find a mutually acceptable sales price. A merchant, to the extent that he operates as an arbitrageur, survives only as long as his profit (the difference between the purchase price and the sales price) is less than the cost to potential buyers and sellers of exchanging the information necessary for a direct sale. Thus, an "exchange" functions by facilitating the direct transfer of information between seller and buyer; while a merchant functions by his ability to effect the same reallocation without any direct transfer of information between seller and buyer.

This court finds that UMIC is neither an unregistered broker-dealer nor an unregistered exchange within the meaning of the Exchange Act.

Registration Under the Texas Blue Sky Act

LTV contends that UMIC violated the Texas Blue Sky Act, *Tex.Rev.Civ.Stat.Ann.* art. 581-1 *et seq.*, by failing to register the Standby Commitment and failing to register as a dealer.

Article 581–5 of the Act provides:

> Except as hereinafter in this Act specifically provided, the provisions of this Act shall not apply to the sale of any security when made in any of the following transactions and made any of the following conditions, and the company or person engaged therein shall not be deemed a dealer within the meaning of the Act; that is to say, the provisions of this Act shall not apply to any sale, offer for sale, solicitation, subscription, dealing in or delivery of any security under any of the following transactions or conditions:
>
> * * * * * *
>
> H. The sale of any security to any . . . savings institution . . . .

Rule 065.05.00.008, 7 *Tex.Admin.Code* § 109.3 (effective May 17, 1976, 1 *Tex.Reg.* 1181), promulgated by the State Securities Board pursuant to its authority under Article 581–28–1, provides:

> The term "savings institution" as used in [Article 581–5(H)] of the [Texas Blue Sky Act], includes any federally chartered credit union or savings and loan association and any credit union or savings and loan association chartered under the laws of any state of the United States.

[20] In that the Texas Blue Sky Act exempts the sale of any security to any

federal credit union,[16] it is inapplicable to the Standby Commitment.[17]

The Alleged Fraudulent Practices

[21] LTV alleges that UMIC violated the anti-fraud provisions of the Exchange Act by (a) knowingly misrepresenting to LTV that the GNMA's would not be delivered, and (b) knowingly failing to disclose the fact that UMIC had entered into a standby commitment with Banco. Although the Standby Commitment is not a "security" within the meaning of the Exchange Act, the GNMA's which UMIC attempted to deliver clearly are, albeit "ex-

16. Citing *Breeding v. Anderson*, 152 Tex. 92, 254 S.W.2d 377 (1953) and *Rowland Corp. v. Integrated Systems Technology, Inc.*, 488 S.W.2d 133 (Tex.Civ.App.—Waco 1972, *writ ref'd* n.r.e.), LTV argues that UMIC nevertheless is in violation of the Act for dealing in unregistered securities because the Standby Commitment is not an "exempt security," as defined by Article 581-6. Neither case is apposite. In *Breeding*, the Court read certain transaction exemptions as being applicable only to transactions by identified individuals, and not to transactions by dealers acting on behalf of those individuals. 254 S.W.2d at 379. Such is not at issue here. Whatever the correctness of *Rowland*, *see* Lebowitz, "Recent Developments in Texas Corporation Law," 28 *Sw.L.J.* 823, 861–873 (1974) (*Rowland* "wrong in terms of grammar, structure, history and policy"), the court's analysis hinges on the effect of the word "nor" in Article 581-34, a matter of no relevance to this case. Moreover, *Rowland* was overruled by amendment of the Article in 1975.

17. Although the anti-fraud provisions of the Act are applicable to exempt transactions, *see* Article 581-33(A)(2), LTV makes no claim thereunder.

empted securities." 15 U.S.C. § 78c(a)(12). Exempted securities are subject to the antifraud provisions of the federal securities laws, and, specifically, to Rule 10b–5. *See Teamsters v. Daniel, supra*, 439 U.S. at 564 n.18, 99 S.Ct. at 799 n.18; *Kubik v. Goldfield*, 479 F.2d 472, 477 (3d Cir. 1973); *In re New York City Municipal Securities Litigation*, 507 F.Supp. 169, 174–75 (S.D.N.Y. 1980).

LTV adduced no evidence at trial of any affirmative misrepresentation by UMIC regarding the possibility of delivery of the GNMA's pursuant to the Standby Commitment. There is no evidentiary foundation for the allegation that UMIC represented that the GNMA's would not be delivered, were not intended to be delivered, or were not normally delivered in the ordinary course of business.

[22] Moreover, even had LTV been able to prove such a misrepresentation, it would not have met its burden of showing justifiable reliance. *See DuPuy v. DuPuy*, 551 F.2d 1005 (5th Cir.), *cert. denied*, 434 U.S. 911, 98 S.Ct. 312, 54 L.Ed.2d 197 (1977). The structure of the Standby Commitment assumes that UMIC will deliver the GNMA's if it is profitable for it to do so, and will not tender them if such is unprofitable. LTV's contention that UMIC represented that it would not deliver the GNMA's begs the unanswered question of why UMIC paid LTV $200,000 in the first place. LTV asks this court to find that UMIC effectively promised LTV a gift of $200,000, and that UMIC was justified in relying on that promise. There is no evidence to support the former proposition, and no logic to the latter.

LTV also asserts that UMIC fraudulently failed to disclose the standby commitment with Banco. As best this court can determine, LTV's argument appears to be that had it known of UMIC's standby commitment with Banco, it would have realized that UMIC would have to deliver the GNMA's to LTV if Banco delivered the GNMA's to UMIC. LTV thus seems to argue that UMIC's standby commitment with Banco increased the possibility of UMIC tendering the GNMA's to LTV under the UMIC–LTV Standby Commitment, and that LTV, therefore, was prejudiced by UMIC's failure to disclose Banco's role.

[23–25] As with an affirmative misrepresentation case, materiality and justifiable reliance are elements of a Rule 10b–5 omissions case. Because of the difficulty of proving reliance in an omissions case, reliance may be presumed where the plaintiff "could justifiably expect that the defendants would disclose material information." *Shores v. Sklar*, 647 F.2d 462, 468 (5th Cir. 1981) (*en banc*). But whether or not LTV's reliance is presumed, the Banco-UMIC standby commitment was not material information.

LTV's argument is bottomed on the assumption that UMIC will only deliver the GNMA's to LTV if Banco delivers the GNMA's to UMIC. The assumption is made in total disregard of the market in GNMA's. If, during the period of the Standby Commitment, the market in GNMA's declines (as it actually did), then UMIC will deliver the GNMA's to LTV whether or not Banco delivers the GNMA's to it. UMIC will do so because it can

purchase the GNMA's on the open market for less than LTV is obligated to pay. To assume that UMIC will forgo that opportunity, is to assume it will forgo profit it paid $200,000 for the chance to make.[18]

If, however, during the period of the Standby Commitment, the market in GNMA's improves, then UMIC will not deliver the GNMA's to LTV whether or not Banco delivers the GNMA's to it. UMIC will not do so because it can sell the GNMA's on the open market for more than LTV is obligated to pay. To assume that UMIC nevertheless will deliver the GNMA's to LTV, is to assume that UMIC will take an unnecessary loss.[19]

Simply put, UMIC's decision to deliver the GNMA's is solely a function of whether delivery is profitable (that is, whether LTV will have to pay more or less than the prevailing fair market value of the GNMA's). The source of the GNMA's—Banco or the open market—is a completely irrelevant consideration. Because the Banco-UMIC standby commitment has no bearing on whether UMIC will exercise its option to deliver the GNMA's to LTV, it is not

18. Since LTV allegedly did not know of the Banco-UMIC standby commitment at the time it executed the Standby Commitment with UMIC, LTV presumably believed that UMIC would purchase the GNMA's on the market if it became profitable for UMIC to do so. *See supra*. That UMIC obtained the GNMA's from Banco rather than on the market is irrelevant to whether it is profitable for UMIC to make delivery.

19. Of course, were UMIC to deliver the GNMA's, LTV would profit beyond the $200,000 commitment fee by selling the GNMA's on the market for more than it paid UMIC.

information which a reasonable man would have attached importance to in deciding whether to execute the Standby Commitment. *See Huddleston v. Herman & MacLean*, 640 F.2d 534, 543 (5th Cir. 1981) (test of materiality is "whether a reasonable man would attach importance to the fact misrepresented [or omitted] in determining his course of conduct.") UMIC thus did not fail to disclose material information by not disclosing the Banco-UMIC standby commitment.[20]

The Tennessee Gaming Statutes

[26] LTV contends that the Standby Commitment is in violation of three Tennessee gaming statutes, *Tenn.Code Ann.* §§ 39–2020 (prohibiting futures contracts made without contemplation of actual delivery), 39–2021 (prohibiting futures contracts limiting profits), and 39–2023 (prohibiting "Bucket Shops").[21] As to each statute, the burden of proving that the accused transaction constitutes a gaming contract rests upon the party making the assertion. *See Palmer v. Love*, 18 Tenn.App. 579, 80 S.W.2d 100, 105 (1935); *Merrill*

20. LTV also claims, without providing any explanation, that UMIC violated 17 C.F.R. § 240.-15cl–6. Presumably, LTV's theory is that UMIC violated the rule by failing to disclose the Banco-UMIC standby commitment. The regulation is inapposite because UMIC is neither a "broker" nor a "dealer who receives or has promise of receiving a fee." Moreover, even if the rule were applicable, this court does not construe the rule to require the disclosure of the Banco-UMIC standby commitment.

21. Sections 39–2020 and 39–2021 were enacted in 1883. Section 39–2023 was enacted in 1909, and amended in 1919. All three statutes were carried over into the 1932 Code.

Lynch, Pierce, Fenner, & Smith, Inc. v. Schriver, 541 S.W.2d 799, 804 (Tenn.App.), *cert. denied*, (Tenn.1976) ("*Merrill Lynch*").

Section 39–2020 provides:

> Any sale, contract, or agreement for the sale of bonds, stock, grain, cotton, or other produce, property, commodity, article or thing, for future delivery, where either of the contracting parties, buyer or seller, is dealing simply for the margin, or on the prospective rise or fall in the price of the article or thing sold, *and where either of the said contracting parties has no intention or purpose of making actual delivery or receiving the property or thing in specie*, shall be deemed and declared gaming. (emphasis added).

See also § 39–2022 (violation of § 39–2020 punishable by fine or imprisonment).

[27] To establish a violation of § 39–2020, LTV must prove that at time of the execution of the Standby Commitment *either* it had no intention of taking delivery of the GNMA's *or* UMIC had no intention of delivering the GNMA's. LTV has not met its burden.

There is no evidence that UMIC did not intend to deliver the GNMA's, provided it was in UMIC's interest to exercise its option. LTV's assertion that UMIC did not intend to deliver the bonds is without factual foundation.

There also is no evidence that LTV, when it executed the Standby Commitment, intended not to take delivery of the GNMA's. Indeed, there was no competent evidence of LTV's intention at the time it entered into

the Standby Commitment.[22] But the evidence does show that for over a year preceding the breach, LTV's Board of Directors reviewed its alternatives (whether to take delivery or breach the agreement), and, in particular, whether LTV was sufficiently liquid to pay for the GNMA's. This court finds that LTV has failed to prove that it did not intend to take delivery of the GNMA's.[23]

Section 39-2021 provides in pertinent part:

> Any sale of any property or thing, or any contract or agreement for such sale, for future delivery, whereby the purchaser is, by the contract or agreement, inhibited from . . . making, realizing, or receiving more than a certain stipulated gain or profit by said sale or purchase, shall be deemed void, and the same is declared gaming.

See also § 39-2022 (violation of § 39-2021 punishable by fine or imprisonment).

In the nearly one hundred years since its enactment, *see* note 21, *supra*, it does not appear that the statute has been directly applied or construed in any reported decision.

22. "The intention that governs the validity of the transaction is that which exists at the time of entering into the contract." *Palmer v. Love, supra*, at 102, 104. *See also* 14 *Williston on Contracts* § 1674 (3d ed. 1972); *Restatement of Contracts* § 523(1) (1932).

23. UMIC correctly notes that if LTV harbored an undisclosed intent not to perform, it would be attempting to void the contract on the basis of its own fraudulent purpose. *See Palmer v. Love, supra*, 18 Tenn.App. 579, 80 S.W.2d at 102.

LTV argues that the Standby Commitment violates § 39-2021 because it inhibits LTV from making more than $200,000 profit. That is, LTV contends that unless UMIC chooses to deliver the GNMA's when it would be unprofitable for UMIC to do so, the Standby Commitment is unenforceable because LTV can realize no more than $200,000 under the agreement.

If LTV's interpretation of § 39-2021 is correct, every option contract governed by Tennessee law is void. An option contract, by its very nature, requires that one party stand by while another party decides whether to exercise the option. *See* pp. 830–831, *supra*. The party that stands by does so for a fee. If the option is never exercised, that fee represents the profit realized by the party standing by. Assuming the party with the option exercises the option only when such is in its economic interest, the party that stands by is limited to a profit of no more than the fee paid for the option. LTV's position thus amounts to a contention that after nearly one hundred years of oblivion, this statute should be construed to void every option contract governed by Tennessee law.[24]

In *Palmer v. Love, supra*, the Tennessee Supreme Court held that option contracts, including "put" options, are not per se gaming transactions. *Id.*, 18 Tenn.App. 579, 80 S.W.2d at 106. That holding cannot be squared with LTV's construction of § 39–2021. *See also* 14 *Williston on Contracts*

24. In that § 39–2021, unlike § 39–2023, is not subject to the savings provisions of § 39–2028, it would not matter whether the option contract was made through the facilities of a legitimate exchange.

§§ 1669, 1669A (3d ed. 1972) (contract giving one party option to sell securities is not wager); 6A *Corbin on Contracts* § 1497 (1951) (same).

[28, 29] This court reads the cited portion of § 39-2021 as a codification of the common law rule that once a delivery price is fixed by the parties, and delivery made, any later settlement reflecting price fluctuations is gaming. As stated by the Alabama Supreme Court, "where the contract fixes a definite price to be paid, in any event, for the transfer of the title, and delivery is then made, and the contract stipulates for an additional settlement based upon the fluctuation of the market thereafter, the stipulation for additional settlement is wager, pure and simple." *South Carolina Cotton Growers' Co-op Ass'n v. Weil*, 220 Ala. 568, 126 So. 637, 642 (1930); *see also Burney v. Blanks*, 136 S.W. 806, 809 (Tex.Civ.App.1911, *writ refused*). Section 39-2021 thus prohibits contracts for future delivery in which the buyer agrees to reimburse the seller for any increases in the market price of the delivered security or commodity after delivery. Such a transaction is not at issue here.[25] To give § 39-2021 the broader construction LTV urges would be contrary to well settled Tennessee

25. UMIC notes that even if the statute were applicable, LTV was not inhibited from making more than a stipulated profit because it had the $200,000 commitment fee to invest during the period of the Standby Commitment. UMIC also notes that if the market in GNMA's had improved after UMIC gave notice of its intention to deliver, but before the settlement date, LTV could have received the GNMA's at a price less than the prevailing market value at the time of actual delivery.

case law that option contracts are not per se gaming transactions.[26]

LTV contends that UMIC is a "Bucket Shop." A "Bucket Shop" is defined as:

> an office, store, or other place wherein the proprietor or keeper thereof, or other person or agent either in his or its behalf, or as an agent or correspondent of any other person, within or without the state, conducts the business of making or offering to make contracts, agreements, trades or transactions respecting the purchase or sale or purchase and sale of any stocks, grains, provisions, or other commodity or personal property wherein both parties thereto, or said proprietor or keeper contemplated or intended that the contracts, agreements, trades, or transactions shall be or may be closed, adjusted, or settled according to or on the basis of the market quotations or price made on any board of trade or exchange upon which the commodities or securities referred to in such contracts, agreements, trades, or transactions are dealt in and without a bona fide transaction on such board of trade or exchange, and the maintenance of any such office, store, or other place of business, and the making of such contracts or agreements shall be and the same are declared illegal and unlawful.

26. It has been held that the validity of futures contracts is found in § 39–2023, and not in § 39–2020. *See Paine, Webber, Jackson & Curtis, Inc. v. Lambert*, 389 F.Supp. 417, 429 (E.D. Tenn.1975), *affirmed*, 6 Cir., 524 F.2d 1405, 1406 ("*Paine, Webber*"). If that is correct, then, by implication, such also would be true of the interrelationship of § 39–2023 and § 39–2021.

Section 39-2023. Persons guilty of operating a "Bucket Shop" are punishable by fine or imprisonment. *See* § 39-2029.

[30] Section 39-2023 establishes a twofold test for determining the illegality of a transaction: (1) *both* parties to the contract must have intended to settle on the margin (2) without effecting a bona fide buy and sell transaction on a board of trade or exchange. *See Paine, Webber, supra*, note 26, at 424-27; *accord, Merrill Lynch, supra*, at 802. It is not necessary to show that the parties did not intend to receive or deliver the commodity. *See Paine, Webber*, at 424; *Merrill Lynch*, at 802.

[31] LTV has not proved that it and UMIC intended to settle on the margin. Specifically, LTV has not persuaded this court that the parties to the Standby Commitment intended that the agreement would be settled on the difference between the contract price and the fair market value at the time of delivery.[27] LTV thus has

27. LTV appears to suggest that the margin maintenance clause should be construed as evidence that the parties intended to settle on the margin. Such an inference is impermissible. *See Merriman & Millard Co. v. Cole*, 198 S.W. 1054, 1056 (Tex.Civ.App.—Ft. Worth 1917, *writ dismissed*). As observed in *Merriman*, margin may serve as security for nonperformance. It has been observed that a margin requirement will "reduce the prospect that the parties to the contract would not be able to make good delivery on the settlement date." Note, "The GNMA Securities Market: An Analysis of Proposals for a Regulatory Scheme," *supra*, at 472 n.83. In this regard, it is difficult to reconcile LTV's contention (made here and in the context of its 10b-5 claims) that it did not expect to have to take delivery of the GNMA's with the fact that it met a $500,000 margin call in 1979. *See supra*, at pp. 824-825.

failed to show that UMIC is a "Bucket Shop."

In sum, LTV has adduced no evidence supporting its claim that the Standby Commitment is in violation of Tennessee gaming statutes.

III.

This court finds that UMIC is entitled to its damages from LTV's nonperformance under the Standby Commitment. The parties disagree on the proper measure of those damages.

UMIC contends that it is entitled to the benefit-of-the-bargain, that being the difference between what LTV is obligated to pay and the fair market value of the GNMA's on the settlement date (July 22, 1980). Under the yield maintenance clause, UMIC is entitled to deliver the GNMA's bearing the most profitable coupon rate. That coupon rate is 12.5%. GNMA's bearing a 12.5% coupon rate had a fair market of $101.87 per security on July 22, 1980, giving a total fair market value of $4,075,-000 for the GNMA's to be delivered by UMIC. LTV is obligated to pay $5,221,250 ($130.53125 per security) for those GNMA's, that being the price producing the same yield as provided for in the Standby Commitment. UMIC's benefit-of-the-bargain thus is $1,146,250.

LTV contends that UMIC is entitled to no damages, never having taken delivery of the GNMA's tendered by Banco pursuant to the Banco-UMIC standby commitment. LTV argues that since UMIC never took delivery of the GNMA's, Banco and UMIC instead having settled their claims, UMIC

suffered no damages as a consequence of LTV's breach. Alternatively, LTV argues that there is no benefit-of-the-bargain which UMIC can recover. Had LTV taken delivery of the GNMA's tendered by UMIC, UMIC presumably would have taken delivery of the GNMA's tendered by Banco. The two transactions would have covered each other, leaving UMIC with no profit beyond the $40,000 difference in commitment fees already paid.

Should this court find that UMIC is entitled to the difference between what LTV is obligated to pay and the fair market value of the GNMA's to be delivered, LTV contends that the damages should be measured using the coupon rate most favorable to it and the fair market value prevailing on the date LTV communicated its intent to breach (June 17, 1980). Using the coupon rate most favorable to LTV—8.5%—UMIC's damages, measured as of July 22, 1980, are $638,750 (market price of $85.03125; contract price of $101). If the fair market value prevailing on June 17, 1980, is used, UMIC's damages are $933,750 (market price of $107.1875; contract price of $130.53125) for 12.5% GNMA's, and $410,000 (market price of $90.75; contract price of $101) for 8.5% GNMA's. It is stipulated that both 8.5% and 12.5% GNMA's were available on the market on June 17, 1980, and July 22, 1980.

[32–34] The measure of damages is determined by Tennessee law, and, specifically, Article 8 (Investment Securities) of the Tennessee Uniform Commercial Code

("UCC").[28] *Tenn.Code Ann.* §§ 47-8-101 *et seq.* GNMA's are "investment securities" within the meaning of § 47-8-102(1) of the UCC. *See In re Legel, Braswell Gov't Sec. Corp.*, 648 F.2d 321 (5th Cir. 1981); *First Nat'l Bank of Chicago v. Jefferson Mtg. Co.*, 576 F.2d 479, 485 (3d Cir. 1978). In that LTV has signed a writing indicating "that a contract has been made for sale of a stated quantity of [GNMA's] at a defined or stated price," the Standby Commitment is enforceable. *See* § 47-8-319(a), (d).[29]

[35] Section 47-8-107 provides that a seller of securities may recover the price against a nonperforming buyer for those

28. The Standby Commitment contains a liability clause that provides:

> As a purchaser from us under mandatory delivery provisions or upon timely notification of intent to deliver securities under optional delivery, you shall be liable to us for any and all losses and reasonable attorneys' fees caused us by reason of any failure by you to accept the Securities in accordance with our agreement, including, without limitation, reimbursement of expenses incurred by us in connection with our agreement, loss of profit to us respecting resale of the Securities agreed to be purchased and resale thereof to our customers at prices designed to give such customers a yield which such customers would have received had the Securities been sold by us to such customers in accordance with agreements between them and us.

Because UMIC did not resell the GNMA's tendered to LTV, the portion of the clause pertaining to resale is inapplicable. The clause by its own terms does not preclude UMIC from pursuing other relief.

29. The yield maintenance clause does not make the price indefinite within the contemplation of § 47-8-319. *See First Nat'l Bank of Chicago v. Jefferson Mtg. Co., supra*, at 485.

securities accepted by the buyer and for other securities if their resale would be unduly burdensome or if there is no readily available market for their resale. Because LTV has not accepted any of the GNMA's, and there is no suggestion that resale of GNMA's is unduly burdensome or that there is no readily available market, the section is inapplicable. Although "investment securities" are expressly excluded from the coverage of Article 2 (Sales) of the UCC, Article 2 may be applied to a situation involving "investment securities" not covered by Article 8 where such application is sensible. *See* "Comments To Official Text," § 47-2-105; *cf., Lindsey v. Stein Brothers & Boyce, Inc.*, 222 Tenn. 149, 433 S.W.2d 669, 671-72 (1968). Courts have held that Article 2 remedies are applicable to sales of "investment securities." *See First Nat'l Bank of Chicago v. Jefferson Mtg. Co., supra; G. A. Thompson & Co. v. Wendell J. Miller Mortgage Co., Inc.*, 457 F.Supp. 996 (S.D.N.Y.1978); *cf. Bache & Co., Inc. v. International Controls Corp.*, 339 F.Supp. 341, 349-50 (S.D.N.Y.1972), *aff'd*, 469 F.2d 696 (2d Cir. 1972).

[36] Under Article 2, where a buyer wrongfully repudiates a contract for delivery of goods, the seller is entitled to the difference between the market price at the time and place for tender and the unpaid contract price. *See* §§ 47-2-610, 47-2-703, 47-2-708. Application of that remedy to this case appearing sensible, this court finds that UMIC is entitled to the difference between the fair market value of the GNMA's on the settlement date (July 22, 1980) and the unpaid contract price.

Citing *Stewart v. Cran-Vela Rental Co., Inc.*, 510 F.2d 982 (5th Cir. 1975), LTV contends that the coupon rate most favorable to it should be used in measuring UMIC's damages. *See also* 11 *Williston on Contracts* § 1407 (3d ed. 1968); *Restatement of Contracts* § 344 (1932). *Stewart* is inapposite, in that there, unlike here, the option of fulfilling one of two alternative promises rested with the breaching party. LTV's argument amounts to a contention that by breaching the agreement before UMIC delivered the GNMA's, LTV preempted UMIC's right to deliver the GNMA's most profitable to UMIC, and, accordingly, most expensive to LTV. Were this court to adopt LTV's reasoning, it would be an open invitation to others similarly situated to repudiate their obligation and thereby minimize their losses. UMIC paid for the right to deliver the GNMA's bearing the coupon rate most profitable to it, and LTV cannot deprive UMIC of that right by refusing to take delivery.[30]

[37] Whatever the merits of LTV's legal arguments concerning alternative promises,

30. There has been some suggestion by LTV that the yield maintenance clause should not be read to permit the delivery of GNMA's bearing any available coupon rate. UMIC adduced evidence showing that its construction is consistent with both industry practice and its understanding at the time of executing the Standby Commitment. There also was evidence that yield maintenance clauses are bargained for provisions in standby commitments. LTV has entered into other standby commitments, some with and some without a yield maintenance clause. No evidence was adduced that LTV did not understand the operation of the yield maintenance clause at the time it executed the Standby Commitment.

this court finds that UMIC gave notice that it would deliver 12.5% GNMA's prior to LTV's repudiation. *See* 11 *Williston on Contracts* § 1407 (3d ed. 1968) (once alternative has been chosen, damages are measured by the value of that alternative); *Restatement of Contracts* § 344, comment a (1932) (same). In its letter of March 24, 1980, UMIC gave notice of its intention to deliver the GNMA's pursuant to the Standby Commitment. Although it did not expressly state that it would deliver 12.5% GNMA's, it used such GNMA's in computing LTV's margin obligations. In its letter of May 21, 1980, responding to LTV's request for clarification, UMIC reiterated its right to deliver GNMA's bearing a coupon rate other than 8.5%. Again, in computing LTV's margin obligations, UMIC used 12.5% GNMA's. This court finds that the letters created an inescapable inference that UMIC would deliver 12.5% GNMA's, and that LTV thus was put on notice of UMIC's intention to deliver 12.5% GNMA's. The appropriate coupon rate for measuring UMIC's damages, therefore, is 12.5%.

This court is not persuaded that because UMIC failed to take delivery of the GNMA's tendered by Banco, it did not suffer any damages as a result of LTV's breach. Certainly, had Banco not tendered the GNMA's, or UMIC otherwise been relieved of its obligation to take delivery, UMIC would be entitled to the benefit-of-the-bargain of the Standby Commitment. LTV's argument that UMIC suffered no damages thus is predicated on its claim that UMIC was relieved of its obligation to take delivery under the Banco-UMIC standby

commitment as a *consequence* of LTV's nonperformance.[31] The evidence, however, does not support the claim.

It is undisputed that UMIC's decision not to take delivery of the GNMA's tendered by Banco was caused by LTV's repudiation of the Standby Commitment. But that does not mean that UMIC escaped its legal obligation to take delivery or that it did not face substantial liability. In fact, although this court makes no ruling on the merits of the claim, it appears that UMIC's contention that Banco had failed to provide written notice of its intention to deliver may have been pretextual,[32] and made to avoid insolvency.[33] UMIC thus did not avoid any cost or expense as a consequence of LTV's failure to perform.

The fact that UMIC and Banco settled their claims through a partial assignment of UMIC's interest in this litigation does not alter that conclusion. Indeed, the settlement is a recognition of UMIC's liability. To find, as LTV urges, that UMIC has

31. *Tenn.Code Ann.* § 47-2-708 provides that a seller is entitled to the difference between the market price and the contract price, *less expenses saved in consequence of the buyer's breach. See also Restatement (Second) of Contracts* § 361 (tent. draft no. 14, 1979) (injured party entitled to loss in value less cost or other loss avoided by not having to perform).

32. Banco apparently gave written notice by letter of June 12, 1980. Whether UMIC received the letter is unclear.

33. In its letters of March 24, 1980, and May 21, 1980, UMIC informed LTV that it would most probably be unable to continue business if it had to purchase the GNMA's and LTV dishonored the Standby Commitment.

suffered no damages because UMIC will pay Banco nothing if this court finds that UMIC has suffered no damages, would be a triumph of circular reasoning.[34]

34. Banco tendered 10% GNMA's, having purchased those from UMIC for the purpose of delivery pursuant to its standby commitment with UMIC. The difference in the fair market value of those GNMA's (as measured on July 22, 1981) and the contract price was $836,875. The Chief Executive Officer ("CEO") of UMIC testified that it is UMIC's policy always to deliver the GNMA's bearing the coupon rate giving it maximum profit; in this case, 12.5%. Thus, even if UMIC avoided an expense as a consequence of LTV's breach, the expense was no more than the $836,875 it would have lost by accepting delivery of the Banco GNMA's. As noted, the difference in the fair market value of the 12.5% GNMA's tendered by UMIC and LTV's contract price was $1,146,250. *See* pp. 839–840, *supra*. Viewing the Banco-UMIC and UMIC-LTV standby commitments as "paired," UMIC's profit from taking the 10% GNMA's and delivering the 12.5% GNMA's would have been $309,375. Taking this "paired" view, LTV's nonperformance deprived UMIC of a profit of $309,375 and exposed UMIC to an uncovered liability (loss) of $836,875.

Despite LTV's assertion that UMIC would have delivered the 10% (Banco) GNMA's had LTV performed, it adduced no evidence to that effect. LTV asserts that UMIC would have passed through the 10% GNMA's because those were the GNMA's it would have had on hand at the time of delivery. But, as noted, UMIC's CEO testified that where UMIC has the option, it delivers securities bearing the most profitable coupon rate to UMIC, and that it intended to deliver such GNMA's to LTV whether or not Banco elected to deliver any GNMA's to it. The parties have stipulated that 12.5% GNMA's were available on July 22, 1980, and UMIC's CEO testified that UMIC easily could have purchased the GNMA's on margin for immediate resale to LTV.

For the stated reasons, UMIC is entitled to recover its damages of $1,146,250.

IV.

[38, 39] UMIC requests pre-judgment interest as of July 22, 1980, at the rate of 10% per annum. Under Tennessee law, an award of pre-judgment interest is in the trial court's equitable discretion. *See Tyber v. Great Central Ins. Co.*, 572 F.2d 562, 564 (6th Cir. 1978); *Farmers Chemical Ass'n, Inc. v. Maryland Casualty Co.*, 421 F.2d 319, 322-23 (6th Cir. 1970).[35] LTV's breach of

35. *Tenn.Code Ann.* § 47-14-123 provides:

> Pre-judgment interest, i.e., interest as an element of, or in the nature of, damages, as permitted by the statutory and common laws of the state as of April 1, 1979, may be awarded by courts or juries in accordance with the principles of equity at any rate not in excess of a maximum effective rate of ten percent (10%) per annum. . . . (effective May 1, 1979).

As of April 1, 1979, pre-judgment interest was a matter of right for liquidated and settled claims. *Tenn.Code Ann.* § 47-14-107. Where an award was not a matter of right, pre-judgment interest was in the equitable discretion of the court. *See Farmers Chemical Ass'n, Inc. v. Maryland Casualty Co., supra.* In that § 47-14-107 was rescinded on April 30, 1979, and § 47-14-123 provides that prejudgment *may* be awarded, it is unclear whether there presently is any entitlement to pre-judgment interest as a matter of right. Because UMIC does not request pre-judgment interest as a matter of right, this court expresses no opinion on whether its claim was liquidated and settled on July 22, 1980. Similarly, since UMIC seeks no more than the 10% maximum rate, this court expresses no opinion on whether the statutory limitation applies to transactions entered into prior to May 1, 1979.

the Standby Commitment was intentional, and made with full knowledge that performance would result in a substantial loss. Since July 22, 1980, LTV has had the opportunity to invest the $1,146,250 and the original commitment fee of $200,000 at interest rates well above 10% per annum. Under the circumstances, this court finds pre-judgment interest proper, and awards interest as of July 22, 1980, at the rate of 10% per annum.[36]

V.

Under the Standby Commitment, UMIC is entitled to its reasonable attorneys' fees. *See* note 28, *supra*. The amount of those fees has been left open for later determination. Within fifteen days of the entry of this Opinion, UMIC's attorneys are to file an affidavit setting forth their reasonable fees incurred in this action. The affidavit is to be accompanied by copies of relevant time records and expense vouchers. Any attorneys' fees incurred with regard to Banco's intervention for which UMIC seeks reimbursement are to be segregated. UMIC also is to submit a brief on the appropriate standard for determining reasonable attorneys' fees, as well as the basis

36. Unless the parties can persuade this court that *Tenn.Code Ann.* § 47–14–121 is inapplicable, post-judgment interest will be set at 8% per annum. *See* 28 U.S.C. § 1961.

for recovery of fees incurred with regard to Banco's intervention.[37]

This court is uncertain as to whether Banco is seeking its reasonable attorneys' fees and court costs. If Banco is seeking its fees and costs, it is to file an appropriate affidavit and brief within fifteen days.

LTV will have fifteen days thereafter to respond. An evidentiary hearing will be scheduled after this court has reviewed the affidavits and briefs. The parties are encouraged to resolve the issue of reasonable attorneys' fees by stipulation.[38]

37. *See Johnson v. Georgia Highway Express, Inc.*, 488 F.2d 714 (5th Cir. 1974); *see also Copper Liquor, Inc. v. Adolph Coors Co.*, 624 F.2d 575 (5th Cir. 1980). If UMIC is seeking its reasonable attorneys' fees should LTV appeal to the Fifth Circuit, and, ultimately, to the United States Supreme Court, it is to file an affidavit setting forth the fees it anticipates incurring on appeal.

38. Because this court finds that T. O. Johnson and LTV had the requisite authority to make the Standby Commitment, UMIC's 10b–5 counterclaim against LTV and the individual directors is DISMISSED

CLARIFYING THE JURISDICTION OF THE SECURITIES AND EXCHANGE COMMISSION AND THE DEFINITION OF SECURITY

JUNE 24, 1982.—Ordered to be printed

Mr. DINGELL, from the Committee on Energy and Commerce, submitted the following

REPORT

[To accompany H.R. 6156]

[Including cost estimate of the Congressional Budget Office]

The Committee on Energy and Commerce, to whom was referred the bill (H.R. 6156) to clarify the jurisdiction of the Securities and Exchange Commission and the definition of security, and for other purposes, having considered the same, report favorably thereon with an amendment and recommend that the bill as amended do pass.

The amendment is as follows:

Strike out all after the enacting clause and insert in lieu thereof the following:

SECTION 1. Section 2(1) of the Securities Act of 1933 (15 U.S.C. 77b(1)) is amended by inserting after "mineral rights," the following: "any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency,".

SEC. 2. Section 3(a)(10) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(10)) is amended by inserting after "for a security," the following: "any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency,".

SEC. 3. Section 9 of the Securities Exchange Act of 1934 (15 U.S.C. 78i) is amended—

(1) by striking out "this section" in subsection (f) and inserting in lieu thereof "subsection (a)"; and

(2) by inserting after subsection (f) the following new subsection:

"(g) Notwithstanding any other provision of law, the Commission shall have the authority to regulate the trading of any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency.".

59-006 O

SEC. 4. Section 28(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78bb(a)) is amended by adding at the end thereof the following new sentence: "No State law which prohibits or regulates the making or promoting of wagering or gaming contracts, or the operation of 'bucket shops' or other similar or related activities, shall invalidate any put, call, straddle, option, privilege, or other security, or apply (except for purposes of chapter 96 of title 18, United States Code) to any activity which is incidental or related to the offer, purchase, sale, exercise, settlement, or closeout of any such instrument, if such instrument is traded pursuant to rules and regulations of a self-regulatory organization that are filed with the Commission pursuant to section 19(b) of this Act.".

SEC. 5. Section 2(a)(36) of the Investment Company Act of 1940 (15 U.S.C. 80a-2(a)(36)) is amended by inserting after "mineral rights," the following: "any put, call, straddle, option, or privilege on any security (including a certificate of deposit) or on any group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency,".

SEC. 6. Section 202(a)(18) of the Investment Advisers Act of 1940 (15 U.S.C. 80b-2(a)(18)) is amended by inserting after "mineral rights," the following: "any put, call, straddle, option, or privilege on any security (including a certificate of deposit) or on any group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency,".

PURPOSE AND SUMMARY

The purpose of H.R. 6156 is to amend the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940 and the Investment Advisers Act of 1940 to expressly include options on securities within the definition of "security" and to clarify the jurisdiction of the Securities and Exchange Commission over options on securities and for certain other purposes.

BACKGROUND

INTRODUCTION

In recent years, the United States financial markets have undergone dramatic and rapid changes. Inflation, high interest rates, a volatile stock market and economic uncertainty have fueled the growth of a number of investment and trading instruments that were either nonexistent or seldom used before the decade of the 1970s. Financial instruments designed to speculate on, or hedge against, fluctuations in interest rates and exchange rates, as well as stock market movements and other economic changes, have proliferated. With the development of innovative financial instruments, the previously drawn lines of regulatory responsibility for these instruments and the markets on which they are traded has become confused. As a result, recently, the SEC's long-standing authority to regulate options on securities and other instruments traded on national securities exchanges has been challenged. Without clarification and confirmation of its authority, the SEC's regulation of the securities and options markets and the SEC's historic mandate to foster the integrity of the markets, protect investors and maintain investor confidence in the markets may be undermined. Thus, capital formation in the form of investments in the U.S. securities markets, may be seriously threatened.

DISCUSSION

Since the enactment of the Securities Exchange Act of 1934, the SEC has had pervasive regulatory authority over trading in securities and the regulation of securities exchanges and market professionals. The federal securities laws were passed in the wake of the stock market crash of 1929. These laws addressed problems created by highly-leveraged speculation, manipulative activities, insider trading and other abuses which were believed to have been responsible for the upheaval in the nation's financial markets. Thus, the securities laws included federally-imposed margin requirements for the purchase of securities on credit, the requirement that issuers file with the SEC a "registration statement" disclosing "material" information before selling securities to the public, and prohibitions against trading on insider information or engaging in manpulative practices in trading securities. These laws were aimed at protecting public investors, assuring market integrity and, most important, restoring investor confidence in order to attract needed funds back into the U.S. capital markets. These goals were, and remain, of paramount concern to Congress.

Because of the need to reach a wide range of instruments marketed to public investors, the term "security" was broadly defined. Thus, the definition of "security" under the federal securities laws includes, among other things, stocks, bonds, notes, investment contracts, "any instrument commonly known as a 'security,'" and any "certificate of interest or participation in" or "right to purchase" a "security." Government-issued and government-guaranteed securities were believed to present fewer risks to investors and, therefore, were exempted from certain provisions of the federal securities laws, including the requirement that a registration statement covering the securities be filed with the SEC prior to sale. These "exempted" securities, which include Treasury securities and GNMA securities [1] are nevertheless subject to the antifraud and certain other provisions of the federal securities laws. For example, the provisions of the federal securities laws which authorize the SEC to regulate trading on national securities exchanges apply to all securities, including exempted securities.[2] Indeed, exempted securities such as Treasury bonds have long been traded on securities exchanges, and such trading has been subject to SEC regulation since 1934.

Although the word "option" is not explicitly included in the definition of "security," a call option on a security is a "right to purchase" a security, and both put and call options or securities are considered instruments "commonly known as" securities.[3] The SEC has exercised jurisdiction over trading in options on securities through its jurisdiction over securities in general under Sections 5, 6, 10, 15, 19 and 23 of

---

[1] Government National Mortgage Association mortgaged-backed pass-through certificates.

[2] *See, e.g.*, Sections 5, 6(b), 10(b), 11(a), 11(b), 15(c), 19(b) and 19(c) of the Securities Exchange Act.

[3] A sell option entitles the holder to purchase from the writer of the options contract a specified quantity of the underlying instrument at a specified price at any time prior to the expiration of the contract. A put option entitles the holder to compel the writer of the options contract to purchase the underlying instrument at a specified price at any time prior to the expiration of the contract.

the Securities Exchange Act of 1934. In addition, Section 9 of the Exchange Act gives the SEC specific and plenary authority to set the terms and conditions of exchange trading of options on equity securities.

While options on securities have served risk-shifting and hedging functions in the securities markets for decades, it was not until 1973 that the first standardized options contracts on equity securities were introduced by the Chicago Board Options Exchange, Incorporated (CBOE). Prior to 1973, securities options were traded exclusively over-the-counter, and the terms of these over-the-counter or "conventional" options contracts generally were the subject of negotiation between a customer and an options dealer. Because of the absence of standardization, secondary trading in conventional put and call options was both costly and difficult. These options still are being written, although this activity has declined substantially since the introduction of exchange-listed standardized options trading. The SEC considers conventional options to be separate securities.[4]

Standardized put and call options trading now takes place on four national securities exchanges and involves the equity securities of more than 300 issuers. Because options are considered separate securities distinct from the securities underlying the options, requirements applicable to the issuance and trading of other securities also apply generally to options trading. For example, the SEC requires registration of options under both the Securities Act of 1933 and the Securities Exchange Act of 1934. Exchanges on which standardized options contracts are listed are subject to registration as national securities exchanges and must comply with the substantive requirements applicable to such exchanges, including submission of all proposed rule changes to the SEC for review and approval. The Options Clearing Corporation, the entity responsible for issuing all standardized options contracts, for clearing options transactions, and for processing the exercise of options, is required to be registered with the SEC as a clearing agency. In addition, brokers and dealers in options must be registered with the SEC.

The Board of Governors of the Federal Reserve System (Federal Reserve Board) has also consistently regulated securities options as separate securities. The Federal Reserve Board is authorized by Section 7 of the Securities Exchange Act to prescribe margin rules and regulations for "securities." The Federal Reserve Board has exercised this authority by prescribing margin requirements for securities options which are different from the requirements established for the underlying stocks.[5]

Options trading is also regulated by national securities exchanges themselves, acting as self-regulatory organizations subject to SEC oversight. Since the beginning of securities exchange trading in options by the CBOE nearly a decade ago, the options exchanges have evolved and adopted rules specifically designed to protect public investors in options in such areas as qualifications of sales personnel, supervision, disclosure and suitability. These protections were recently strengthened following an extensive study of the options markets.

[4] *See, e.g., Dean Witter & Co.* CCH Fed. Sec. L. Rep. Paragraph 78.602, January 5, 1972.

[5] *See* 12 C.F.R. Sec. 220.3(1).

which was instituted at the direction of the SEC and reported to Congress.[6]

For example, options exchange rules require that all employees of member firms who sell options to the public must first pass a qualifying examination. The accounts of options customers and the sales practices of options salespersons must be supervised by a "Registered Options Principal," who is required to pass a comprehensive written examination relating to options. In addition, the member firms must designate a "Senior Registered Options Principal," who is an officer or general partner of the firm, to be responsible for overall supervision of options customers' accounts. The prospectus prepared by the Options Clearing Corporation, which describes the terms and conditions of listed options contracts and the risks involved in trading options, must be delivered to every customer at or prior to the time a customer account is approved for options trading. Special "suitability" rules have been adopted which prohibit a broker from recommending that customers engage in options transactions unless the broker has made reasonable inquiry concerning the customer's investment objectives and financial situation, and has a reasonable basis for believing that the customer is capable of evaluating the risks of the transaction.

Proposals by national securities exchanges to trade options on government securities under SEC regulation first were submitted for SEC consideration in 1977. While there were no challenges to the SEC's authority to approve and regulate options on government securities, these proposals were withdrawn at the SEC's request, in accordance with the SEC's temporary moratorium on the expansion of new options producting pending the results of its special study of the equity security options markets.[7]

When the options moratorium was ended by the SEC in 1980, and after the adoption of rules responsive to the extensive recommendations included in the options study, securities exchanges again proposed to trade options on government-issued and government-guaranteed securities. This time, however, the SEC's authority to regulate options on exempted securities was challenged by the Chicago Board of Trade (CBOT), which had already begun trading futures on government-issued and government-guaranteed securities[8] and feared competition from the securities exchanges.[9] In a recent decision on the

---

[6] *Report of the Special Study of the Options Markets to the Securities and Exchange Commission*, 96th Cong., 1st Sess. (Comm. Print 96-IFC3).

In general, the Options Study found that options can provide useful alternative investment strategies to those who understand the complexities and risks of options trading. But, since regulatory inadequacies in the options markets have been found, the Options Study is making specific recommendations needed to improve the regulatory framework within which listed options trading occurs and to increase the protection of public customers. Letter of transmitted, *Options Study*, p. V.

[7] *See* Securities Exchange Act Release No. 15027 (August 3, 1978).

[8] Although options and futures are quite different they may serve similar economic functions in some respects and, therefore, may compete for the same group of investors, hedgers or speculators. An option grants the right but *not* the obligation to buy or sell a specific quantity, at a specific price on or before a specified future date. A future grants the right *and* imposes the obligation to purchase or sell a specific quantity at a specific price and at a specific future date.

[9] In *Board of Trade of the City of Chicago v. SEC*, 14 BNA Sec. Reg. L. Rep. 578, (7th Cir., March 24, 1982) (hereafter *CBOT v. SEC*), the court noted:

Important for understanding the motivation behind this and related lawsuits, however, is the great similarity of functions served by the two GNMA derivatives and the tremendous revenue they may generate for the exchanges on which they are traded.

CBOT's lawsuit, the court said that the SEC did not have authority to regulate options on GNMA securities. Although the decision may be reversed on appeal, it could seriously undermine the SEC's long-standing authority to regulate the securities options market, unless there is statutory clarification of that authority.

Need For Legislation

As stated above, although the SEC since its creation in 1934 has regulated the trading of options on securities under numerous provisions of the federal securities laws, the definitional sections of the securities laws do not expressly include the word "option" within the definition of "security." For most of its history, the SEC's authority to regulate options on securities was unchallenged. However, when the Commodity Futures Trading Commission (CFTC) was created in 1974 and was given exclusive jurisdiction over trading in commodity futures, the potential for jurisdictional conflict was born. The 1974 Commodity Exchange Act (CEA) amendments, which established the CFTC, expanded the definition of "commodity" to include "all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in." The phrase could potentially be interpreted to mean that anything that became the subject of futures trading would automatically become a "commodity" and subject to the exclusive jurisdiction of the CFTC.

If interpreted too broadly, provisions of the CEA would constitute a severe and unnecessary intrusion upon the jurisdiction of the SEC. However, the legislative history of the CEA amendments shows that such a result was not intended by Congress when the CEA was amended in 1974 and again in 1978. For example, while it generally was understood that the CFTC could authorize futures on exempted securities such as GNMAs and Treasury instruments, the legislative history of the CEA shows that CFTC authorization of futures trading on individual corporate securities was not contemplated.[10] Similarly, the legislative history indicates that the jurisdiction granted to the CFTC over commodity options was not intended to preempt or affect the authority of the SEC to regulate put and call options on securities.[11]

It also is significant that certain provisions of the CEA were designed to preserve the jurisdiction of the SEC and confine the scope of the CFTC's authority. For example Section 2(a)(1) of the CEA provides that, except for those matters over which the jurisdiction of the CFTC is exclusive, nothing in the section shall "supercede or limit the jurisdiction at any time conferred on the Securities and Exchange Commission." That section also provides that "nothing in this Act shall be deemed to govern or in any way be applicable to transactions in * * * security warrants, security rights * * * government securities, or mort-

[10] *See Report of the House Committee on Agriculture to Accompany H.R. 10285*, H.R. Rep. No. 95-1181, 95th Cong., 2d Sess. 14 (1978) ("House Report No. 1181").

[11] *See, e.g., Report of the Senate Committee on Agriculture and Forestry to Accompany H.R. 13113*, S. Rep. No. 93-1131, 93d Cong., 2d Sess. 26 (1974) where it is stated that:

> [T]he [CFTC] would not have authority to regulate trading in puts and calls for securities. Where traded on exchanges, these puts and calls are regulated by the Securities and Exchange Commission.

gages and mortgage purchase commitments, unless such transactions involve the sale thereof for future delivery conducted on a board of trade."

It is clear that Congress, in creating the CFTC, did not intend to limit the SEC's jurisdiction over options on securities. However, the expansive language of the CEA, together with the failure of the securities laws to explicitly identify options as separate securities, has led to legal challenges to the SEC's authority. Although these challenges were generated by the competitive interests of the commodities exchanges, which were candidly recognized by even the Seventh Circuit Court of Appeals in the CBOT case against the SEC, the CFTC joined the legal fray, as an amicus curiae, supporting the CBOT's position in its lawsuit. While the CFTC ultimately embraced a detente with the SEC, and thereafter ceased to be an active participant in the litigation, for a time at least the two agencies were involved in unseemly arguments over their respective jurisdictions in federal court. Surely for public policy reasons, if no other, Congress must consider this a wholly inappropriate result.

In hearings before the Subcommittee on Telecommunications, Consumer Protection and Finance on June 17 and 18, 1981, witnesses addressed the issue of SEC and CFTC jurisdiction. Subsequent to the hearing, Chairman Wirth requested proposals for legislative language to clarify the jurisdictional problem. In addition, during the fall of 1981 meetings were held with administration officials, industry members and legal experts to discuss resolution of the issues. A number of proposals were reviewed by the Subcommittee staff during this time. For example, proposals were submitted which would allocate to the SEC clear jurisdiction over all derivative instruments based on securities. Pointing to differences in requirements governing sales practices and other investor protections, some proposals recommended that the allocation of jurisdiction to the SEC should be based upon whether an instrument is sold to public investors.

During this time, the SEC and the CFTC determined that it was in the public interest to reach an agreement on the manner in which each agency should interpret its statutes. Following a series of meetings, an accord was reached by the agencies in December, 1981 and in February, 1982, draft legislative proposals were submitted to Congress.[12]

While the legislation proposed by the agencies, as well as other proposals, was being reviewed by this Committee, the decision in the CBOT's lawsuit against the SEC cast uncertainty over the SEC's jurisdiction to regulate options on exempted securities and other non-stock options.[13] The court stated that exchange-traded standardized put and call options on GNMA securities were not themselves securities. The court also concluded that the sole authority of the SEC to

[12] *See* CCH Fed. Sec. L. Rep. Paragraph 83,096, February 2, 1982, setting forth the terms of the accord and the legislative proposals. The proposed amendments delineating the CFTC jurisdiction over futures were included as part of the CFTC reauthorization legislation, H.R. 5447, initially considered in the Committee on Agriculture and sequentially referred to this Committee. Proposed amendments clarifying the SEC's jurisdiction with respect to securities options were sent by the agencies to this Committee.

[13] *CBOT v. SEC*, footnote 8, *supra*. *See also Board of Trade of the City of Chicago v. Securities and Exchange Commission*, No. 82-1097, pending in the same court, which challenges the authority of the SEC to regulate options trading on Treasury securities.

regulate put and call options on securities exchanges is derived from Section 9 of the Securities Exchange Act. The court also was of the view that options on GNMA securities were subject to the exclusive jurisdiction of the CFTC.

The court noted its lack of "a complete understanding of the differences" between options and futures contracts. The court also noted that the statutes at issue "are complex enough to admit different opinions of their proper construction." The wide divergence of the majority and dissenting opinions in the 2–1 decision of the court underscores the lack of clarity in the existing statutes. The dissenting opinion (Cudahy) noted that the majority's decision reflected a "bizarre" and "extreme" conclusion. The Committee believes the court's decision is not consistent with long-standing Congressional intent that the SEC has the sole authority to regulate options on all securities, including exempted securities.

Following the decision, concerns were raised by a number of industry members and legal experts that the court's decision could have disruptive ramifications far beyond the SEC's ability to regulate GNMA options. For example, by concluding that options on GNMA securities are not themselves securities, the court has raised serious questions about the Federal Reserve Board's authority to prescribe margin requirements for options on equity securities. The decision also raises questions about the states' ability to play an enforcement role with respect to fraud or other violations in the trading of such options. If the CFTC were to have exclusive jurisdiction over these instruments, states would be preempted from enforcing state securities laws with respect to fraudulent activity in the trading of these options.

The decision also raises doubts about whether the SEC could require the registration of stock options under the Securities Act of 1933, or enforce liability for misstatements in prospectuses, since the relevant Securities Act provisions apply only to the offer and sale of "securities." Additional doubts are raised about whether the insurance protections provided by the Securities Investor Protection Act for the options customers of securities broker-dealers will apply. Moreover, the decision raises the possibility that the Chicago Board Options Exchange, which trades only securities options, may not be considered a "national securities exchange" within the meaning of the Securities Exchange Act of 1934.

In response to these concerns, on April 22, 1982, H.R. 6156, which would clarify the SEC's jurisdiction over options, was introduced with bi-partisan support.[14] On April 23, 1982, a hearing on the legislation was held in the Subcommittee on Telecommunications, Consumer Protection and Finance. Witnesses testified that passage of H.R. 6156 would remedy the problems discussed above by providing explicit statutory language delineating the SEC's jurisdiction over options on securities and other financial instruments traded on national securities exchanges.

---

[14] While H.R. 6156 is substantially similar to legislation proposed by the SEC as part of its jurisdictional accord with the CFTC, it differs in certain respects. For example, H.R. 6156 would amend Section 28 of the Securities Exchange Act of 1934 to create a limited federal preemption of state anti-gaming laws with respect to cash settlement options approved by the SEC for trading on national securities exchanges. H.R. 6156 does not contain an express exclusion of SEC authority over options on futures, which was proposed in the SEC's draft legislation but was not believed to be legally significant.

In supplemental responses submitted for the hearing record, witnesses also addressed the issue of potential problems that might be created by state regulation of stock index options, which are new instruments proposed to be traded on securities exchanges. These contracts, because they may be settled by payment of an amount of cash equal to the difference between the exercise price and the value of the index on the expiration date, instead of by delivery of the underlying securities, could be subject to attack under state anti-gaming and "bucket shop" laws.[15] Similar application of state laws would not apply to futures contracts settled in cash, because the CEA gives the CFTC exclusive jurisdiction over futures trading thereby preempting state anti-gaming and bucket shop laws, as well as other state laws.

It is the Committee's view that there should be a federal policy with respect to instruments trading in interstate commerce. Thus, options contracts approved for trading by the SEC pursuant to the rules of national securities exchanges, and which could potentially benefit public investors by providing mechanisms for risk-shifting, should not be prevented from trading by state laws which were historically designed to prevent unregulated gambling activities.

Major Provisions of the Legislation

H.R. 6156 would amend the definition of "security" under four of the federal securities statutes expressly to include options on securities, options on certificates of deposit, options on securities indices or groups and, when traded on a national securities exchange, options on foreign currency.

While under the federal securities laws the SEC has regulated the securities options markets for many years, this legislation would confirm the intent of Congress that the SEC has sole authority to regulate options on securities and groups and indices of securities, including exempted securities. In order to resolve any uncertainty, the definition of the term "security" in the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, and the Investment Advisers Act of 1940 would be amended to include explicitly among the instruments enumerated any put or call option on a security.

While the amended definition of "security" would make it clear that put and call options are themselves securities, the Commission would retain its authority to treat such securities as "exempted" securities. The Committee believes that such treatment is appropriate for certain over-the-counter options, such as the optional delivery contracts employed by the Federal Home Loan Mortgage Corporation in connection with its mortgage purchase and securities sale activities.

The legislation would also make it clear that the SEC has explicit authority to regulate options on securities groups and indices and certificates of deposit and, when traded on a national securities exchange, options on a foreign currency. This would be accomplished by amending the definitions of "security" to include specifically options on securities groups and indices and on certificates of deposit, as well as on options contracts relating to foreign currency entered into on a national securities exchange.

---

[15] *See Chicago Board of Trade v. Christie Grain & Stock Co.*, 198 U.S. 236 (1905).

Certain national securities exchanges have proposed to trade, as a package, groups of individual stocks. Since the SEC has the authority to regulate trading in the individual securities composing the group, the Committee believes that it has ample authority to regulate trading in the group. This bill would provide an express statement of that authority.

The status of certificates of deposit as securities under the Securities Act and the Securities Exchange Act has not been completely free from doubt. *See Marine Bank* v. *Weaver*, Current CCH Fed. Sec. L. Rep. Paragraph 98,471 (U.S. March 8, 1982) (holding that, under the circumstances of the case, a certificate of deposit issued by a bank subject to regulation by a domestic bank regulatory agency is not a security for purposes of the Securities Exchange Act, but leaving open the question of whether a certificate of deposit could be a security in another context). However, certificates of deposit consistently have been considered "securities" by the Securities and Exchange Commission for the purposes of the Investment Company Act. In order to emphasize that no change in current law in this regard is contemplated, the legislative language used in the two circumstances differs slightly. Thus, for Investment Company Act purposes, the relevant portion of the definition of security reads "* * * option * * * on any security *including* a certificate of deposit," while the corresponding language in the Securities Act and the Securities Exchange Act reads "* * * option * * * on any security, *or* certificate of deposit * * *" (italic supplied).

The SEC's authority over options trading is further clarified by amendments to Section 9 of the Securities Exchange Act to establish that the SEC's plenary options authority in that Act extends to options on exempted securities, and to make clear that SEC authority extends to regulate the trading of options on all securities and securities groups and indices, on certificates of deposit, and, when traded on a national securities exchange, options on foreign currency.

A limited preemption of state anti-gaming and bucket shop laws is also provided for options contracts approved by the SEC for trading on securities exchanges. These contracts would remain subject to all applicable state anti-fraud, securities and other laws.

Hearings

The Committee's Subcommittees on Telecommunications, Consumer Protection and Finance and Oversight and Investigations held a joint hearing on H.R. 6156 on April 23, 1982. Testimony and supplemental information was received from 14 witnesses, representing 14 organizations, with additional material submitted by six individuals and organizations.

Committee Consideration

On May 13, 1982, the Committee's Subcommittee on Telecommunications, Consumer Protection and Finance met in open session and approved the bill H.R. 6156 by a voice vote, a quorum being present.

On June 16, 1982, the Committee met in open session and ordered reported H.R. 6156, with two amendments, by a voice vote, a quorum being present.

Report of the Joint Treasury–SEC–Federal Reserve Board Study of the Government-Related Securities Markets

December 1980

[Selected Portions]

PREFACE

The following study of the government-related securities markets was prepared by the Department of the Treasury, the Federal Reserve System and the Securities and Exchange Commission (SEC) pursuant to a request by Senator Harrison A. Williams, Jr., Chairman of the Subcommittee on Housing and Urban Affairs, for information and advice on problems arising in these markets, particularly in the forward market for mortgage-backed securities guaranteed by the Government National Mortgage Association.

The study deals only with the cash and forward markets for certain government-related securities and does not attempt an evaluation of either the futures market for these securities or the proposed options market in the same securities.

It should be noted that, although the Treasury staff has fully participated in this study, the Administration has not taken a position on the study's recommendations. The SEC and the Board of Governors of the Federal Reserve System have endorsed the recommendations.

TABLE OF CONTENTS

CHAPTER I

INTRODUCTION AND SUMMARY OF STUDY'S CONCLUSIONS AND RECOMMENDATIONS

This report presents the results of a study of markets for government guaranteed securities and other related securities that has been conducted jointly by the U.S. Treasury, the Federal Reserve and the Securities and Exchange Commission (SEC). The study was prompted by the widespread problems--attributable in great part to abusive trading practices--recorded in government guaranteed securities markets in recent years, particularly the market for mortgage-backed securities guaranteed by the Government National Mortgage Association (GNMA). Trading activities in these markets are currently exempt from federal regulation--except for the SEC's antifraud authority. The purpose of the study was thus to consider whether federal regulation should be extended to these markets, and, if so, to develop proposals for how this might best be accomplished.

In the course of the study, interviews were conducted with federal agencies that either guarantee or issue securities currently exempted from SEC regulations or are responsible for regulating financial institutions that invest in such securities. Interviews were also held with various entities in the private sector including interested trade associations, issuers, dealers and investors in government guaranteed securities. 1/ The cases in which the SEC has instituted actions in response to complaints about abusive practices in government related securities have also been reviewed. Other background information was obtained from within the agencies conducting the study.

The following chapters present the results of these efforts. Chapter II provides a broad overview of federal and federally assisted borrowing and reviews the history of legislation that has exempted such debt securities from SEC regulation. Chapter III presents a summary review of the major characteristics of securities, the market participants, and the trading practices in the government related securities markets. The discussion is supplemented by five appendices that provide more detail on the market sectors described. Chapter IV provides a review of problems and abuses that have developed in various sectors of the government related securities market and an analysis of regulatory measures that, if imposed, would reduce such abusive practices. An appendix providing a detailed review of cases in which the SEC has instituted

---

1/ See list of those interviewed at the end of this chapter.

legal actions accompanies this chapter. Chapter V reviews the various actions taken by federal agencies charged with regulating issuers of and investors in government guaranteed mortgage-backed securities and other government related securities, and also discusses the efforts made by the securities industry to establish a self-regulatory framework.

Finally, Chapter VI examines the question whether regulation should be extended to brokers and dealers in government related securities and sets forth conclusions and recommendations. These conclusions and recommendations are summarized in the following sections of this chapter. They are also embodied in a legislative proposal that is being submitted by the three agencies in connection with this study. That legislative proposal is presented as Appendix B to Chapter VI.

Conclusions

After carefully reviewing and evaluating problems which have arisen in the trading of government related securities and taking into account the opinions of other interested federal agencies and market participants, it is the joint view of the Treasury, Federal Reserve and SEC that there is need to extend government regulation to forward trading in GNMA guaranteed mortgage-backed securities. Losses suffered by market participants trading in these securities have been substantial. It is recognized that the potential for problems to develop in the future has been reduced as a result of the rules and guidelines imposed by GNMA on issuers and by federal regulatory authorities on financial institutions that invest in these securities. Prospects for serious abuse, however, appear to remain unacceptably great. In particular, it is still possible to assume large positions in GNMA securities for long delayed delivery without being required to provide an initial or maintenance margin--the practice that has contributed to a high degree of speculative activity and, thus, to losses incurred by dealers and investors in these securities.

To date, there have been only a few instances in which investors have incurred losses in forward transactions in mortgage-backed securities guaranteed by the Federal Home Loan Mortgage Corporation (FHLMC) because of abusive trading practices. Nevertheless, these securities are also traded on a forward delivery basis without margin, and thus the potential exists for serious problems to develop in this market sector similar to those recorded in GNMA forward trading. Accordingly, it has been concluded that forward

trading in FHLMC guaranteed mortgage-backed securities should come under the same mantle of regulation as that imposed on GNMA forwards.

As for the other sectors of the government and government related securities markets, it appears that the small number of problems in these sectors does not presently warrant elimination of the exemption of these securities from formal federal regulation (except for the SEC's antifraud statutes). There have been only a few cases of abusive practices that have involved these other sectors, and losses have been relatively small compared with those recorded in mortgage-backed securities as well as with the total volume of transactions in these markets. Moreover, a major portion of these markets is subject to the informal oversight of the Federal Reserve System and the Department of the Treasury.

Recommendations

The regulatory system that appears best suited to extend regulation over forward trading in GNMA and FHLMC guaranteed mortgage-backed securities is one based on self regulation with governmental oversight, a system that has worked well in other sectors of the financial markets. Accordingly, it is proposed that a new self-regulatory organization, which would be named the Federal Mortgage-Backed Securities Rulemaking Board (Board), be established to promulgate rules to be followed by brokers and dealers trading on a forward basis in GNMA and FHLMC guaranteed mortgage-backed securities. This "Board" would be composed of representatives of bank and nonbank securities dealers and public representatives, including investors. It would have authority to set initial margin and margin maintenance requirements for forward transactions in GNMA and FHLMC securities. In addition, if deemed necessary, it could establish financial and fair practice standards and other rules.

The proposed Board would exercise rulemaking authority subject to the oversight of a Council composed of the Secretary of the Treasury, the Chairman of the Federal Reserve Board, and the Chairman of the Securities and Exchange Commission, or their respective designees. The Council would have the power to approve or disapprove the rules of the Board and to abrogate, add to, or delete from such rules. Before taking actions that would affect trading practices in markets for GNMA and FHLMC securities, the Council would be required to request and consider the views of GNMA and FHLMC. Brokers and dealers, including bank dealers, trading in GNMA and FHLMC securities on a forward basis would be required to register with the Council, although the Council would delegate this registration function, in the first instance, to the

SEC. Clearing agencies for forward trading in GNMA and FHLMC securities would also be subject to registration and oversight.

Governmental entities other than the Council would also be assigned certain direct rulemaking responsibilities. While the Board's margin setting authority would be exercised under the general review of the Council, the Federal Reserve Board would be given residual rulemaking authority in this area, and any margin rules it might promulgate would take precedence over those of the Board. Also, the SEC would have antifraud rulemaking authority. All nonbank securities dealers trading in GNMA and FHLMC securities on a forward basis, moreover, would be required to become members of the Securities Investors Protection Corporation (SIPC) and subject to its requirements.

To assure compliance with the rules promulgated by the Board, primary inspection and enforcement authority would be allocated to the National Association of Securities Dealers (NASD), national securities exchanges, and the federal bank regulatory agencies, with concurrent enforcement authority in the SEC. This is similar to the division of responsibilities currently followed in ensuring compliance with rules established by the Municipal Securities Rulemaking Board. Thus, such an approach would appear likely to minimize costs associated with such activities for both the government and securities dealers.

It is proposed that the Board be given authority, subject to unanimous approval of the Council, to extend regulatory controls to cash transactions in regulated securities where necessary or appropriate with respect to the regulation of forward transactions. Further, the Council would have the authority, by unanimous vote, to extend regulation to transactions in other government related securities (but not to Treasury securities). While such an extension of federal regulation does not appear to be necessary at the present time—except perhaps to the extent that effective regulation of forward transactions in GNMA and FHLMC securities may require some regulation of the cash markets—the availability of this authority would facilitate such actions, should this be warranted by future developments.

APPENDIX C

GNMA GUARANTEED MORTGAGE-BACKED SECURITIES

The Government National Mortgage Association (GNMA) was established in 1968 through amendment to the National Housing Act. Set up as a government corporation within the U.S. Department of Housing and Urban Development, GNMA administers two major types of mortgage support programs. Through its Special Assistance Function (SAF), which was inherited from the Federal National Mortgage Association (FNMA) when that agency was converted to a privately owned

corporation in 1968, GNMA carries out a number of interest rate subsidy programs designed to provide support for specific types of housing. Secondly, GNMA administers the Mortgage-Backed Securities (MBS) Program, which was designed to increase liquidity in the secondary mortgage market and attract new private sources of funds into residential loans. Under the MBS program, GNMA guarantees the timely payment of principal and interest on passthrough securities that are issued by private financial institutions and are based on pools of government-underwritten residential mortgages that are originated by private lenders.

Formation of the Mortgage Pools

The mortgage pools backing issues of GNMA-guaranteed securities consist primarily of FHA-insured and VA-guaranteed home loans and Farmers Home Administration home loans. Other types of government-underwritten mortgages also have been pooled in limited amounts: FHA-insured multifamily construction loans, FHA-insured long-term multifamily mortgages, and FHA-insured and VA-guaranteed mobile home loans (table 1).

The minimum pool size is $1 million for home mortgages and $500 thousand for multifamily and mobile home loans. Mortgages making up a pool must be uniform with respect to type of dwelling and coupon interest rate, and the loans must be less than one year old. 1/ The home mortgages have a maximum maturity of 30 years, whereas the multifamily mortgages may run as long as 40 years.

The pools of government-underwritten loans backing issues of GNMAs ordinarily are formed by private mortgage originators without the involvement of GNMA's own funds. In some cases, however, the mortgage pools have been made up of FHA/VA loans sold by GNMA--loans that GNMA previously had acquired under its Special Assistance Function programs in connection with the single-family "tandem plans." In these cases, the mortgages were sold back to the originators who then assembled the mortgage pools, issued the GNMA-guaranteed securities, and placed them with the syndicates of security dealers that bid the highest prices in the MBS auctions conducted by GNMA. GNMA has not pur-

1/ There are exceptions for the mobile home loan program.

Table 1
GNMA-GUARANTEED PASSTHROUGH SECURITIES BY TYPE OF POOL
(December 31, 1979)

Type	Original balance ($ thousands)	Percent distribution	Number of pools
Single-family	$85,869,831	93.8	32,929
Project loans	1,810,032	2.0	437
Construction loans	825,415	.9	97
Mobile homes	1,057,910	1.2	1,159
Graduated payments	1,857,518	2.0	862
Serial notes	129,283	.1	26
Sub-total	$91,549,989	100.0	35,510
Terminated pools	720,977		385
Total issues	$92,270,966		35,895

Source: Government National Mortgage Association.

chased mortgages under the tandem plan since 1976. 2/ In the event that the single-family tandem plan is resurrected to help limit cyclical downswings in residential mortgage activity, this link between the SAF and MBS programs may reappear.

Before GNMA-guaranteed securities are issued, the mortgages assembled in the pools to back them are removed from the balance sheets of the originating institutions and are placed in trust with a GNMA-approved custodian (usually a commercial bank). The custodian examines the documents, certifies their authenticity, and holds them for safekeeping; these documents, and payments of mortgage principal and interest received by GNMA issuers but not yet passed through to investors, represent GNMA's collateral for the guarantee. 3/

Characteristics of the GNMA-Guaranteed Certificates

A GNMA-guaranteed passthrough certificate is a claim on a share of the income from a specific pool of government-underwritten mortgages. The certificates are issued by private institutions that originate the mortgages and assemble the pools. The originator/issuer generally continues to service the mortgages in the pools, collecting principal and interest payments from mortgagors and passing payments through to the holders of the securities. GNMA guarantees that the issuers will maintain payments of principal and interest from the mortgages to holders of the securities on a timely basis. The GNMA guarantee of issuer performance is backed by the full faith and credit of the U.S. government. GNMA has unlimited authority to borrow from the Treasury to meet its obligations under the guarantee.

The GNMA-guaranteed certificates currently being issued are passthrough securities that are "fully modified" in the sense that scheduled monthly payments of principal and interest from mortgages in the pool are provided to the holder of the security, whether or not collected by the mortgage servicer, plus a pro rata share of any unscheduled recoveries of principal. 4/ Sales of mortgaged property are the most important cause of prepayment prior to contract maturity, but refinancings and foreclosures also can be significant factors. Thus, the cash flow to investors may vary from month to month depending on the distribution of terminations for mortgages in the pool.

GNMAs that represent shares in pools of 30-year FHA/VA home loans generally are characterized by participants in the market as securities with expected lives of 12 years. 5/ The 12-year life assumption is based upon termination experience with FHA-insured loans accumulated over many years. This experience suggests that, on average, half of the mortgages in a pool will be terminated by the twelfth year.

The coupon rate on a GNMA single-family security is set 50 basis points below the contract rate on the mortgages in the pool, and this contract rate ordinarily is equal to the FHA/VA ceiling rate prevailing at the time the pool is formed. The servicer of the mortgages receives 44 basis points and GNMA receives a guarantee fee of 6 basis points. The 44-point servicing charge is 6-1/2 basis points higher than that typically earned by servicers of whole FHA/VA loans. This extra income compensates the GNMA servicer for administrative costs and for ensuring timely payment of principal and interest to the security holders, whether or not received from the mortgagors.

2/ GNMA purchased $6.9 billion of single-family FHA/VA mortgages under the tandem programs between November 1971 and September 1976, and resold $4.9 billion of the loans during 1975-76 to syndicates of security dealers through auctions of mortgage-backed securities. The remainder were sold by GNMA through whole-loan auctions, and they generally were declared by GNMA to be eligible for pooling.

3/ In addition to the mortgage documents, the custodian holds an unrecorded assignment in favor of GNMA.

4/ Some straight passthroughs were issued when the GNMA program first started, but almost all outstanding GNMAs are now fully modified.

5/ Yields on securities issued against pools of 40-year multifamily mortgages usually are quoted on the basis of prepayment in 20 years.

The minimum denomination for a newly issued GNMA-guaranteed passthrough security is $25,000; beyond this minimum, GNMAs are available in increments of $5,000. Securities representing shares in pools of mortgages that are partly paid off, of course, will have correspondingly smaller amounts of unpaid balances. Moreover, some securities dealers have organized GNMA mutual funds or unit investment trusts, with individual shares priced at $1,000.

GNMA-guaranteed certificates are issued only in registered form. However, the certificates are fully transferable and assignable; that is, they may be endorsed by the owners and assigned to other investors without reregistration. In these cases, of course, the cash flow from the mortgage pool continues to flow to the registered holder.

Participants in the GNMA Market

Issuers. GNMA has specified a number of eligibility requirements for issuers of GNMA-guaranteed passthrough securities. Issuers must be FHA-approved mortgage lenders and approved by FNMA as mortgage servicers. GNMA also has established net worth requirements for issuers. Until October 1979, the minimum required net worth was $100,000 and the requirement could range only up to $250,000; within this range, the requirement depended on the type (single-family, multifamily, etc.) and the amount of securities issued. Under regulations implemented in October 1979, the net worth requirement is related to the type and amount of securities issued, with no set maximum. For example, an issuer of single-family GNMAs must have net worth of $100,000 plus one percent of the amount of securities outstanding in excess of $5 million but less than $20 million, plus 0.2 percent of any additional securities outstanding in excess of $20 million.

The major issuers of GNMA-guaranteed securities are mortgage companies, which originate the bulk of government-underwritten home loans (more than 80 percent in 1979). More than 900 institutions have issued GNMAs, and nearly two-thirds of the issuers have been mortgage companies--most others have been depositary institutions (table 2). Moreover, issue volume has been concentrated among a relatively small number of large institutions. The fifty largest issuers, (47 of which are mortgage companies) have accounted for nearly half of the total volume of GNMA issues.

Investors. In the early days of the GNMA securities program, the nonbank thrift institutions (S&Ls and mutual savings banks) were the major investors in GNMAs; in 1971, these institutions held nearly 70 percent of outstanding GNMAs. By the mid-1970s, the thrifts still held nearly half the volume of GNMAs outstanding, although diversified investors were entering the market in increasing numbers. Yields on GNMAs increased sharply relative to yields on Treasury and corporate securities in 1974 as the thrift institutions substantially reduced their purchase of GNMA securities in response to contracting deposit flows, and the large yield advantage helped overcome conceptual problems that had discouraged participation by some types of institutions. After the cyclical trough in 1975, the range of investors participating in the GNMA market broadened markedly.

As can be seen in table 3, by the end of 1979 holdings of the nonbank thrift institutions accounted for only about one-fourth of all outstanding GNMAs; the remainder was spread among every major category of investor. As the thrift institution share of the market declined in recent years, the shares of most other types of investors rose. A notable exception has been credit unions, where the share dwindled from nearly 7 percent in 1971 to about 2 percent in 1979. Investment by private individuals has remained between one and two percent of the total since the inception of the program.

Table 2
ISSUERS OF GNMA-GUARANTEED PASSTHROUGH SECURITIES BY TYPE OF INSTITUTION
(December 31, 1979)

	Number of firms	Percent of total
Mortgage companies	573	63.7
Savings and loan associations	170	18.9
Commercial banks	124	13.9
Mutual savings banks	22	2.4
Credit unions	1	negl.
Other	10	1.1
Total	900	100.0

Source: Government National Mortgage Association.

Table 3
PERCENT DISTRIBUTION OF HOLDINGS OF GNMA-GUARANTEED PASSTHROUGH SECURITIES BY TYPE OF INVESTOR
(1979 month ended)

Investor groups	October	November	December
Mutual savings banks	10.0	9.9	9.8
Commercial banks	6.0	6.0	5.9
Savings and loan associations	15.1	15.2	15.3
Public retirement/pension funds	9.9	9.7	9.6
Private retirement/pension funds	.2	.2	.2
Mortgage bankers	3.1	2.9	2.6
Securities brokers/dealers	4.0	4.2	4.0
Nominees	26.7	27.5	28.8
Corporations/partnerships	10.3	9.9	9.3
Private individuals	1.6	1.5	1.6
Credit unions	2.2	2.2	2.1
Life insurance companies	3.1	3.1	3.0
Other insurance companies	.3	.3	.3
State & local govt. gen. funds	5.9	5.9	5.9
Fiduciary - individual	.2	.2	.2
Fiduciary - institutional	.5	.4	.5
Others	.1	.1	.1
Terminated issues	.8	.8	.8
Percentage	100.0	100.0	100.0
Total issued	$87,126,327	$90,376,424	$92,270,966

Source: Government National Mortgage Association.

While the participation of pension and retirement funds--major investor targets of the program--has increased, only about one-eighth of outstanding GNMAs are registered in the names of private (noninsured) and state and local government pension and retirement funds. Some portion of the large block of GNMAs registered in the name of nominees apparently represents investment by pension and trust funds, but the amounts involved are unknown. The figures for commercial banks include securities held in their trust departments--also an unknown quantity.

Institutions of all sizes have been attracted to GNMAs because of favorable yields and the high degrees of quality and liquidity. Federally guaranteed mortgage passthrough securities (primarily GNMAs) account for roughly three percent of the total assets of S&Ls in all size groups (table 4). At credit unions, some GNMAs are held by institutions in all but the smallest size groups (those with total assets under $100 thousand), but GNMAs account for more than three percent of total assets only in the largest size group (table 4). Only about 350 of the nearly 11,000 federally insured credit unions with total assets under $1 million held GNMAs at the end of 1978.

Table 4
GNMA-GUARANTEED PASSTHROUGH SECURITIES HELD BY SAVINGS AND LOANS AND CREDIT UNIONS BY SIZE OF INSTITUTION
December 31, 1978
(Dollar amounts in thousands)

	Insured savings and loan associations		
Asset size group	Number of institutions	GNMA securities held	Percent of total assets
Less than $10 million	381	$62,203	2.7
$10-25 million	788	418,814	3.1
$25-50 million	904	912,928	2.7
$50-100 million	838	1,863,860	3.1
$100-250 million	729	3,691,061	3.2
More than $250 million	413	9,130,265	3.1
Total	4,053	$16,079,127	3.1

	Insured credit unions		
Asset size group	Number of institutions	GNMA securities held	Percent of total assets
Less than $500 thousand	8,124	$2,168	0.1
$500 thousand-$1 million	2,704	5,136	0.3
$1-2 million	2,288	7,258	0.2
$2-5 million	2,039	51,971	2.7
$5-10 million	944	67,169	1.0
$10-20 million	540	129,180	1.7
$20-50 million	355	285,093	2.6
More than $50 million	127	766,096	5.9
Total	17,121	$1,314,100	2.6

Sources: Federal Home Loan Bank Board, National Credit Union Administration.

Brokers and dealers. Most firms making markets in GNMAs are members of the Mortgage-Backed Securities Association--now a division of the Public Securities Association. 6/ The association was established in 1972 to further development of the secondary market in GNMAs, and there currently are about 75 members of the group, including a number of major securities firms and commercial banks. A broker/dealer need not be a member of this group in order to trade GNMAs, and there are an estimated 20 nonmember firms currently active in the GNMA market.

6/ The group originally was called the GNMA Mortgage-Backed Securities Dealers Association. The name was changed twice--to the Mortgage-Backed Securities Dealers Association and then to the Mortgage-Backed Securities Association--and the group recently merged with PSA.

Some transactions are arranged by firms serving merely as brokers between buyers and sellers. In most cases, however, the firms act as dealers in GNMAs, buying and selling securities on their own accounts. The major dealers are in the market continuously, making it possible for buyers and sellers to take or dispose of positions in GNMAs without significant delay. Over-the-counter trading conditions prevail in the dealer market; transactions take place on a negotiated basis and contract terms are not standardized.

Distribution and Trading of GNMAs

New issues and the dealer market. An institution considering issuance of GNMAs against pools of FHA, VA, or FmHA mortgages it has acquired or plans to acquire must apply to GNMA for commitments to guarantee. GNMA commitments are available, in amounts up to the net worth limits discussed earlier to authorized issuers, regardless of market conditions, at a fixed fee that does not vary with the amount of the commitment. The GNMA commitments are good for at least one year (they may be extended an additional 60 days), and they provide for pooling of loans bearing any FHA/VA ceiling rate in effect during the commitment period.

Receipt of the GNMA commitment does not obligate the mortgage originator to issue GNMAs. Indeed, a mortgage originator that has obtained a GNMA commitment to guarantee and is accumulating an inventory of FHA/VA/FmHA mortgages may market the mortgages in a number of ways. He may commit to sell new issues of GNMAs to dealers in the forward cash market under a "mandatory" delivery contract. 7/ Alternatively, the originator may decide to wait until he has assembled a group of mortgages; then he may sell blocks of whole loans to investors (such as S&Ls or life insurance companies) or place them in pools and issue GNMAs for immediate delivery to private investors or to securities dealers. During the "assembly" period, the originator may cover the risk of price fluctuation on mortgage inventory by obtaining optional-delivery or "standby" purchase commitments from GNMA dealers or from FNMA, or through a hedge in the GNMA futures market. 8/ And in the cases where interest rates have risen relative to rates on mortgages accumulated in inventory, the originator may find it profitable to deliver mortgages to FNMA or to sell GNMAs to dealers under optional-delivery commitments obtained earlier. In recent years, mortgage companies have marketed most of the government-underwritten loans they originate either by issuing GNMA certificates or by selling whole loans to FNMA.

Forward prices for mandatory future delivery of new issues of GNMAs (those with coupons 50 basis points below the current or recent FHA/VA ceiling) are published by some dealers. The deferred-delivery prices generally are lower than the immediate-delivery prices for GNMAs when long-term interest rates are above short-term rates. Thus if a mortgage company utilizes forward commitments at the dealers, it forfeits some or all of the warehousing profits that are derived while assembling the pool of mortgages in a positive-carry market. 9/ On those occasions when the term structure is inverted and there is a negative-carry, mortgage companies incur losses on mortgage warehousing and deferred-delivery prices available at dealers usually rise above immediate-delivery prices for GNMAs.

As the volume of trading in GNMAs has grown and the resale risk assumed by dealers has declined, spreads between bid and asked prices on new issues have fallen from more than 1 percentage point in the early days of the program to as little as 1/32 of a point--at least under normal market conditions. The price spread for new issues generally is the same for immediate

---

7/ If delivery fails to be made under a mandatory delivery contract, the mortgage company is liable for any loss sustained by the buyer due to nondelivery.

8/ Four-month standby commitments may be obtained from FNMA through the biweekly Free Market System commitment auctions or through FNMA's 12-month convertible standby commitment program.

9/ The cost-of-carry element--the difference between long- and short-term interest rates--usually dominates the pattern of forward-delivery prices, but interest rate expectations also can have an effect. Thus, the difference between immediate and forward delivery prices does not necessarily match the net gain or loss on mortgage warehousing.

delivery and for mandatory delivery in the forward market. Moreover, dealers ordinarily have not required mortgage companies to post margin to secure forward contracts.

Mandatory commitments for delayed delivery of new issues of GNMAs protect issuers against price declines during the period required to assemble the mortgage pools, but these contracts also prevent them from taking advantage of price increases. Optional-delivery or "standby" purchase commitments eliminate the disadvantage of mandatory commitments for mortgage bankers in periods of rising securities prices. 10/ To obtain this greater flexibility, the mortgage banker must pay a fee to the party agreeing to "stand by."

The GNMA dealers make markets in optional-delivery or standby contracts providing for delivery up to a year or more later. The optional-delivery standby commitment issued by the GNMA dealer is, in essence, a "put" option handled in an informal, over-the-counter options market. The fee paid by the mortgage banker to the dealer is negotiated. So is the "striking price," the price at which a GNMA with a specified coupon can be sold to the dealer upon the exercise of the standby commitment. A dealer issuing a standby may decide to reduce his risk exposure by obtaining a similar commitment from an investing institution to which he pays the bulk of the standby fee received from the mortgage company. In periods of rising interest rates, the cost of standbys at the dealers can increase considerably since the issuer of the standby (dealer or investor) is more likely to receive delivery of GNMAs priced below the market. At FNMA, on the other hand, fees for standby commitments are constant regardless of market conditions.

In the forward market (mandatory or optional), contracts between mortgage companies and securities dealers generally include an equivalent-yield clause that permits delivery of GNMAs issued against pools of mortgages bearing either the current FHA/VA ceiling rate or other ceiling rates that might be established during the life of the contract. Standard conversion factors, based upon the assumption of 30-year term and prepayment in 12 years for all coupons (in the case of securities issued against pools of home mortgages), establish delivery prices for various coupons that will produce yields "equivalent" to those agreed upon for the current coupon. 11/

Delayed-delivery contracts generally also specify that the securities delivered cannot be priced higher than par. This "par cap" reflects the reluctance of investors to absorb capital losses that accrue as premium securities approach maturity. It also protects dealers and investors against the possibility of outright losses that could occur on premium securities in the event of rapid prepayment of mortgages in the pools, and it limits the dollar outlay required of buyers that had committed to purchase a given amount of GNMAs (par value). 12/ On the other hand, the par cap can create complications for mortgage companies when the FHA/VA ceiling is increased; mortgages originated under the higher ceiling might have to be priced below market to meet a commitment to deliver GNMAs under an "equivalent" yield contract. Under such conditions, of course, the mortgage companies may buy the lower-coupon FHA/VA mortgages or GNMAs in the market to meet the commitments.

Investors often buy GNMAs for immediate delivery in the cash market. Some investors also buy GNMAs under mandatory-delivery arrangements in the forward cash market as a way of locking in asset yields at some margin over their anticipated costs of funds; such forward pricing of mortgage investments has been regarded as a legitimate form of hedging by the regulators of depository institutions, such as the FHLBB. Some also may issue standby commitments to buy in the future, receiving front-end fees in return. The demand for forward delivery commitments by GNMA issuers, however, need not be met by the supply of commitments issued by permanent investors. Speculators, who accept interest rate risk in the hope of making profits from changes in the market, provide a bridge between mortgage companies and mortgage investors. Moreover, securities dealers may take substantial positions on their own accounts.

10/ Standby commitment agreements generally specify that the seller must give 30 to 60 days notice of intent to deliver. At that point, the commitment becomes mandatory.

11/ As discussed below, actual market prices for various GNMA coupons may differ from the prices generated by this equivalent-yield formula.

12/ Rapid paydowns of premium securities can occur if market interest rates decline and the high-rate mortgages in the pools are refinanced by the borrowers.

The GNMA futures market. An organized futures market in GNMA-guaranteed securities has been in operation at the Chicago Board of Trade since late 1975, providing ways of hedging against interest rate changes for GNMA issuers, investors and dealers. Actual delivery is generally not made on the futures market, because positions usually are offset before the futures contracts expire.

Mortgage bankers may sell GNMA futures contracts as a temporary substitute for a sale in the cash market. This "short hedge" tends to balance the risk of a long position in the cash market associated with the accumulation of mortgage inventory for later sale; losses incurred in the cash market when mortgage prices are falling should be approximately offset by gains realized on the futures contracts when the mortgage banker closes out its futures market position by buying back the contract at a profit (if mortgage prices are rising, the situation is reversed). On the other hand, companies committing to sell GNMAs in the forward market may simultaneously secure a "long hedge" in the futures market by buying an equivalent amount of futures contracts. Indeed, any institution committed to buy or sell GNMAs in the forward market may hedge this position by taking a position in the futures market equal to and opposite from its forward market position.

Hedging in the futures market involves some costs, such as brokerage commissions and opportunity costs associated with initial and maintenance margin requirements. 13/ Moreover, many mortgage companies hesitate to use the futures market because they prefer to hold open the possibility of capital gains on mortgage inventory while limiting the possibility of capital losses through use of optional-delivery standby commitments (from FNMA or from GNMA dealers). Some mortgage companies also had been deterred by complications surrounding the delivery instrument known as a collateral depositary receipt (CDR), formerly called a due bill, which was developed by the Chicago Board of Trade. 14/ In 1978, the American Commodities Exchange developed a GNMA futures contract allowing for settlement of short positions via delivery of actual GNMA certificates, and the Chicago Board of Trade subsequently added a similar contract. The CBOT's original GNMA contract market, however, remains by far the largest GNMA futures market.

Secondary market trading of GNMAs. About $48 billion of GNMAs were reregistered in 1979 (table 5). Moreover, dealers estimate that the actual volume of secondary market trading was substantially larger (perhaps by a factor of 10) due to trades involving assignment but not registration--primarily among the securities dealers. Until recently there was no central clearing house, and most transactions in GNMAs have been settled by individual dealers, either by delivery or by pair-offs and difference checks to settle trades.

Yields on the higher-coupon securities traded in the secondary markets usually are higher than those on the lower-coupon securities (under the standard 12-year average life assumption). There apparently are two reasons for this difference. First, higher coupon issues have shorter expected maturities because there is a higher probability of early prepayment of the mortgages in the pools than there is for the mortgages in the low-coupon pools. Second, the price and yield pattern may also partly reflect tax considerations. The ratable share of discount income obtained by acquiring a newly issued GNMA at a discount from par must be reported to the Internal Revenue Service as ordinary income. But recoveries of price discounts on seasoned issues acquired in the secondary market--which arise because market interest rates decrease after issuance--are considered to be capital gains for tax purposes. Thus, for investors with marginal income tax rates above the tax rates for capital gains, deeply discounted issues will be relatively attractive, ceteris paribus. The favorable tax status of low-coupon GNMAs is an important factor in the determination of yield spreads among GNMAs with various coupons, in view of the important role of taxable institutions in this market.

Repurchase agreements. Securities dealers enter into repurchase and reverse-repurchase agreements in GNMAs. From the dealer's perspective, a repurchase agreement involves a sale of GNMAs for immediate delivery and a commitment to buy back an equivalent amount of the securities at a future date at

---

13/ The broker charges a "round turn" commission to sell and then buy a futures contract.

14/ Under this delivery system, the mortgage banker had to maintain a collateral pool of GNMAs to back his CDRs until they were surrendered.

the same price, plus a sum of money that yields a prearranged rate of interest over the period of the contract; for dealers, this is basically a financing transaction or borrowing. A reverse repo, on the other hand, involves the purchase of securities by a dealer and a commitment to sell back an equivalent amount of the securities at a specified price on a specified future date; an agreed-upon interest rate is earned by the dealer over the life of the contract, and for financial reporting the transaction is treated as a receivable collateralized by the security purchased.

Table 5
GNMA-GUARANTEED PASSTHROUGH SECURITIES TRANSFERRED IN SECONDARY MARKET
(Millions of dollars)

Month	1972	1973	1974	1975	1976	1977	1978	1979
January		250	432	660	1,193	3,388	4,021	3,580
February		283	495	805	1,475	3,177	3,491	2,820
March		218	735	1,002	1,959	4,711	3,105	3,177
April	240	273	668	1,313	2,440	3,164	2,747	2,830
May	307	170	532	972	2,513	3,732	2,724	2,987
June	243	309	529	935	1,901	3,588	2,775	3,230
July	186	396	495	1,151	2,190	3,596	2,334	4,392
August	192	303	454	773	2,169	3,525	3,030	5,093
September	140	165	447	817	2,783	3,985	3,043	4,365
October	187	218	511	851	2,886	3,319	3,408	5,990
November	247	259	429	786	3,392	3,331	3,086	4,744
December	224	296	555	1,099	4,120	3,432	2,966	5,016
Total	1,966	3,140	6,282	11,164	29,021	42,948	36,930	48,224

Source: Government National Mortgage Association.

Some major dealers advertise bid and asked interest rates for terms of 30, 60, and 90 days on repos, identifying an interest rate spread generally around 1/2 percentage point. However, as in other components of the market, practices are not standardized. Initial margins (in the form of price markdowns) may or may not be required, and the repurchase agreement may or may not be "marked" to the market in the event of price fluctuations. The securities may be re-registered, but it is customary to keep the securities in the name of the original owner during the period of time they are pledged as collateral under a repurchase agreement. However, in some cases the security "repurchased" may not be the same security that was sold. In the case of such "money" repos, collateral substitution is allowed and yield maintenance and par cap provisions are involved.

From an investor's perspective, a reverse repo with a dealer is a method of turning securities held in portfolio into cash for a short period at interest rates that may be favorable, relative to other short-term interest rates available in the market. An investor may do a repurchase agreement to raise short-term funds without actually liquidating his assets. For some institutions, such as S&Ls, this can be an important mechanism for raising cash without taking losses when GNMA prices are depressed.

The MBS Clearing Corporation. In 1979, the MBS Clearing Corporation was established to offer services providing risk reduction and settlement cost savings to firms active in the GNMA forward market. Mortgage bankers, investors, and dealers may participate. The list of participants in early 1980 is shown in table 6.

On each day, MBSCC, utilizing the Midwest Clearing Corporation as facilities manager, produces two reports for each participant--a "Purchase and Sales Report" and an "Open Commitment Report." The P & S Report lists all pertinent information on each trade entered the previous day and serves as a formal comparison and confirmation of each trade. This Report eliminates the need for the exchange of commitment letters by both parties to a trade.

The Open Commitment Report is a detailed listing of all forward trade commitments that have been entered and have not yet been settled. The Report provides participants with a surveillance tool for open trades. It is from information contained in this Report that MBSCC calculates a daily mark-to-the-market for each participant. Each participant is required to post directly with MBSCC, or through an approved bank, a letter of credit, cash or qualified securities in an amount equal to 100 percent of any debit margin balance. This must be done within twenty-four hours after notice from MBSCC.

Settlement cost savings for participants result from MBSCC's ability to net trades each settlement month into a substantially fewer number of balance order deliveries than a firm would achieve by pairing off open trades with another firm. MBSCC routinely nets over 90 percent of all trades while firm-to-firm pair-offs normally net only 50 to 60 percent.

Table 6
PARTICIPANTS IN THE MBS CLEARING CORPORATION

ACLI Government Securities
Bach
Cantor Fitzgerald Agency
COMARK
Countrywide Funding
Dean Witter Reynolds
First Boston
Garban Ltd.
Goldman Sachs*
Hilliard Farber
JPC Brokers
Kidder Peabody
Loeb Rhoades
Merrill Lynch
MKI Government Securities
Neuberger Berman
Oppenheimer
Paine Webber
Salomon Brothers
S. E. First National Bank*
Thompson McKinnon

* Applied for participation.

Source: MBS Clearing Corporation.

CHAPTER IV

REVIEW OF CASES OF ABUSIVE TRADING PRACTICES IN MARKETS FOR GOVERNMENT RELATED SECURITIES AND OF REGULATORY MEASURES TO REDUCE SUCH PROBLEMS

The federal securities laws apply, among other things, to the original distribution of securities, and the trading of already issued securities. The Securities Act of 1933 ("1933 Act") seeks to ensure effective disclosure in the original distribution of corporate securities by mandating that specific documents be given to investors and filed with the Securities and Exchange Commission ("SEC"). 1/ To complement this system of specifically mandated disclosures by issuers, the 1933 Act has a broad anti-fraud provision, Section 17(a), which applies to the offer or sale of any security, whether or not subject to the Act's registration requirements.

The trading of already issued securities is generally covered by the Securities Exchange Act of 1934 ("1934 Act"), which contains provisions on both the disclosure of information and the substantive conduct of broker-dealers as well as other participants in the securities markets. Like the 1933 Act, the 1934 Act has a general anti-fraud provision, Section 10(b), which applies to the purchase or sale of any security by any person. At the same time, the 1934 Act establishes specific standards of conduct and prophylactic measures through a combination of self-regulation and direct rulemaking by the SEC. Congress charged the securities exchanges in 1934 and the National Association of Securities Dealers ("NASD") in 1938--referred to as self-regulatory organizations ("SROs") 2/--with the primary responsibilities for the conduct of their respective members. But the authority of SROs is subject to the SEC's supervision. For example, under Section 19(b) of the 1934 Act, SROs must file all proposed rule changes with the SEC, which must take affirmative action to approve or disapprove most such proposed rule changes. 3/ And, under Section 19(d) of the 1934 Act, the SEC is authorized to review any final disciplinary sanction imposed by an SRO upon a member. Moreover, Congress empowered the SEC to engage in direct rulemaking with respect to various trading practices, such as short-selling, 4/ and various aspects of broker-dealer operations like financial responsibility. 5/

1/ Sections 5 and 10 of the 1933 Act.

2/ Other SROs include the Municipal Securities Rulemaking Board and registered clearing agencies.

3/ See also Section 19(c) of the 1934 Act.

4/ Section 10(a) of the 1934 Act.

5/ Section 15(c)(3) of the 1934 Act.

Although government related securities are subject to the aforementioned anti-fraud provisions of the 1933 Act and the 1934 Act, the majority of the Acts' requirements do not apply to such securities. The 1933 Act exempts government related securities from the registration requirements of that Act. 6/ Similarly, the 1934 Act effectively exempts broker-dealers trading solely in government related securities from most SRO and SEC rules governing the conduct of securities trading. The dealer registration provisions of the 1934 Act, for example, allow unregistered dealers to trade in these exempted securities; 7/ and the recordkeeping provisions are applicable only to registered brokers, dealers, municipal securities dealers, and certain other specified persons. 8/

As mentioned above, 9/ Congress exempted government related securities from most of the regulatory provisions of the federal securities laws largely because of the federal guarantee of interest and principal. However, no government guarantee can protect against the risk of substantial price swings and attendant liquidity impairment resulting from sharp changes in interest rates. This risk is most pronounced in the market for mortgage-backed securities, which are long-term obligations commonly bought or sold for delivery four to six months into the future without any margin requirement. Moreover, a number of other factors have added to the potential for problems in government related securities, especially relating to forward trading in mortgage-backed securities:

(1) the significant changes in the economic environment for government related securities;

(2) a marked increase in the volume of government related securities sold to the public;

(3) smaller, less sophisticated institutions and individuals increasing their participation in these markets; and

(4) a substantial number of new and relatively small dealers participating in the government related markets.

Of course, problems have not materialized in a large proportion of the trades in government related securities. As indicated above, 10/ the trading markets for such securities involve approximately $300 to $500

6/ Section 3(a)(2) of the 1933 Act.

7/ See Section 15(a)(1) of the 1934 Act, together with that Act's definition of "exempted security" in Section 3(a)(12).

8/ Section 17(a)(1) of the 1934 Act.

9/ See Chapter II, *supra*.

10/ See Chapters II and III, *supra*.

billion on an annual basis. And, while precise statistics are not available, it appears that the great majority of these trades have been conducted in an open, honest manner by investors, dealers and issuers. Nevertheless, there have recently been a disturbing number of reported cases involving serious abuses in the trading of government related securities. Most of these cases involve mortgage-backed securities--most importantly GNMA securities and to a lesser extent FHLMC securities.

Below we summarize the major abuses that have occurred in the trading markets for government related securities during the past five years. In the light of these abuses, we then review the regulatory measures imposed on registered broker-dealers trading in non-exempted securities and the possible application of such measures to trading in government related securities, and the regulatory measures voluntarily adopted by certain dealers trading in government related securities.

Extent of Abuses

During the last five years, the SEC has instituted a number of enforcement proceedings and investigations involving government related securities. Appendix A presents summaries of 28 such cases and investigations. These include the SEC proceedings that have been completed during the last five years, and other proceedings and investigations for which a substantial amount of information is available. Not included are other SEC investigatory proceedings at preliminary stages of development. Moreover, the press has recently issued reports on at least four other government related securities cases involving significant sums.

While some of the 28 cases in the Appendix involve a variety of securities and different types of abuses, the cases can be grouped into several major categories. Of the 28 cases, 23 involve primarily government related mortgage-backed securities, two cases involve other government related securities, and three cases involve Treasury securities. Of the 23 cases concerning government related mortgage-backed securities, 16 primarily involve overcommitments in connection with forward transactions, three principally involve misuse of customer funds or securities, and the remaining four involve various problems such as churning, adjusted trading, and interpositioning. Of the 16 overcommitment cases, investors became over-committed at least in part because of questionable sales practices of dealers in seven, investors became overcommitted as a result of their own speculation in three, and dealers themselves became over-extended or suffered related financial problems in six cases.

Unregistered dealers were the main cause of the problems in 10 of the cases; in nine cases dealers registered with the SEC were involved in abusive conduct. Four cases involved both registered dealers and unregistered affiliates. The problems in the remaining cases were caused by a mortgage banker, a financial officer of a university, and others. While no firm figures concerning the total losses resulting from the 28 cases are available, it is estimated that those incurred by customers of dealers trading in GNMAs were $70-94 million while dealers absorbed an additional $15 to $17 million in losses. To the extent that further breakdowns can be made, it appears that between $53 million and $77 million of losses have occurred in cases involving unregistered broker-dealers, while between $7 and $14 million of losses have occurred in cases involving registered broker-dealers.

In addition, the press has recently reported at least four other cases involving significant losses in connection with GNMA forward commitments. These cases involve two savings and loan associations, a mortgage banker, and a governmental jurisdiction. One savings and loan with assets of about $233 million has filed suit against 11 brokerage firms alleging, among other things, that the brokerage firms sold it "hundreds of millions of dollars" in "grossly unsuitable" GNMA forward transactions. 11/ The Federal Savings & Loan Insurance Corporation ("FSLIC"), in order to protect $175 million in customer deposits, recently took over another savings & loan that was unable to meet its extensive GNMA forward commitments. The FSLIC has already paid almost $80 million for GNMA forward commitments, and the savings and loan still has outstanding commitments to buy $500 million in GNMAs—almost three times its total deposits—through mid-1981. 12/ In the third case, a county fund refused to take delivery of $20 million in GNMA forwards, thus avoiding a $3 million loss, and sued its former treasurer and a broker-dealer to recover $5.5 million in losses allegedly suffered as a result of unauthorized and illegal trades. 13/ And, a mortgage banker with extensive GNMA forward and futures commitments is engaged in litigation with at least 3 broker-dealers over several million dollars allegedly lost as a result of speculative activity in these markets by several of the mortgage banker's principals. 14/

11/ Wall Street Letter, Feb. 25, 1980, at 1.

12/ Wall St. J. March 26, 1980 at 16.

13/ Business Week, March 10, 1980, at 44.

14/ See, e.g., Barrons, Nov. 12, 1979 at 4.

Furthermore, interviews with state regulators and federal agencies 15/ indicate that there have been many other instances in which financial institutions have suffered significant losses in trading government related securities. These problems have typically occurred at small banks, savings and loan associations, and credit unions. While the sharp increase in interest rates in recent years has contributed greatly to liquidity problems, a substantial number of such institutions have lost large sums, relative to their resources, in transactions that were ill-suited to their financial positions and needs. The most common cause of these problems has been the acceptance of relatively large forward commitments for mortgage-backed government related securities without full appreciation of the risks associated with increases in interest rates. Sharp or high-pressure sales practices by certain dealers have contributed to these problems in the first instance; then in many cases complex financing and accounting schemes have been used in attempts to cover-up the difficulties and postpone recognition of the losses.

Below is a review of the major categories of abuses revealed by the SEC cases in Appendix A. Citations, by case number, to Appendix A are provided where appropriate for illustration. In a number of cases more than one abuse was present so some cases are cited in several categories. This review also draws upon the above mentioned interviews with various government regulators and market participants.

Overcommitments

The most dangerous problem to date in the market for mortgage-backed, government related securities has been the assumption of large forward delivery commitments by institutions and individuals without sufficient assets to enter into such risks. In some cases, over-commitments by relatively unsophisticated investors have been encouraged by dealers, frequently through the use of sales tactics like those described below. In other instances, however, apparently sophisticated investors such as mortgage bankers have made conscious decisions to speculate in government related mortgage-backed securities and have assumed patently excessive positions while concealing the full extent of their commitments from the dealers involved. For example, one mortgage banker speculating in GNMA forwards told each of 10 to 12 dealers that it had made no commitments with any other dealer or was dealing with only one or two other dealers. In fact the mortgage banker, which had a net worth of approximately $2 million, had substantial commitments with each of the 10 to 12 dealers, had commitments

15/ See Appendix B for a list of the persons, firms, and agencies interviewed in connection with this report.

exceeding $50 million with each of three, and had acquired net "long" commitments of over $350 million coming due over the following five months. (See, e.g., cases 1, 4, 8, 9, 10, 11, 19, 21, 25, 26.)

In several cases, dealers themselves have become over-committed, and this has led to their bankruptcy, with accompanying defaults on their commitments to customers and to other dealers. In other cases, customer defaults led to serious financial problems for the dealers that had sold the forward commitments. (See, e.g., cases 2, 4, 7, 13, 14, 17, 19, 28).

A fundamental factor conducive to the over-commitment problems experienced in government related mortgage-backed securities has been the absence of margin requirements. The lack of such restrictions has allowed excessive leveraging and speculation in forward commitments for these securities. Likewise, the absence of such restrictions has enabled investors to use repurchase agreements as a device to "pyramid" holdings—that is, an original investment in government related securities serves as collateral for an entire series of additional purchases by the same investor. In either case, a significant rise in interest rates can create large unrealized losses on the transactions. (See, e.g., cases 2, 4, 9, 14, 19, 21.)

Sales and Trading Practices

Unsuitable recommendations and transactions. Closely related to the problem of over-commitments is the problem of dealers making recommendations to their customers that are unsuitable in view of the interest rate risks associated with the trading of government related securities and the financial circumstances and objectives of the investors. In most cases, unsuitable transactions involved forward commitments—either mandatory or "stand-by"—to purchase GNMAs. The investors have often been small institutions such as banks, savings and loans, other thrift institutions, and credit unions, but other entities such as universities, local governmental units, and individuals have also participated in clearly unsuitable transactions. All of the regulatory agencies interviewed in connection with this study agreed that unsuitable recommendations and sales have been a major factor behind the problems in forward trading of government-guaranteed securities. (See, e.g., cases 1, 4, 11, 13, 14, 15, 19, 25).

Among the examples described in Appendix A, one dealer sold forward commitments to purchase $5 million worth of GNMAs to a credit union with total assets of only $1 million and sold $21 million in commitments to a bank with total assets of $11 million. In another case, a salesman placed well over a million dollars worth of GNMA forward commitments in the account of an individual

who had a very small net worth and who had asked to be informed immediately if losses reached $2,500. (See, e.g., cases 4, 7; cf. case 10.)

High-pressure sales methods and inadequate disclosure. Many of the unsuitable transactions and positions evident in government related securities have resulted from use of high-pressure sales tactics and inadequate disclosures by dealers and salesmen. These sales methods have been used with respect to both individuals and small, institutional investors. Polished presentations stressing large returns, with little or no initial cash expenditure, have commonly been made, in some cases through "cold calls" to persons or institutions listed in directories but otherwise unknown by the salesman. Moreover, certain dealers have misrepresented their own financial conditions to prospective investors, and one unregistered government securities dealer falsely held itself out as registered, a member of the NASD, and insured by the Securities Investor Protection Corporation. (See, e.g., cases 4, 10, 13.)

Some salesmen have omitted information that repeated GNMA trades in a customer's account can substantially reduce or eliminate the return that could otherwise be expected. There are also cases in which dealers, in selling forward commitments, have neglected to mention the large losses that investors can sustain on these forward commitments if interest rates change. In some cases, salesmen have even extended assurances that buyers would not have to take delivery of the subject GNMAs but could sell the contract at a profit at the settlement date, finance the purchase, or extend the commitment. Other salesmen have also told financial institutions that they could increase their current reported earnings by taking into current income fees from writing stand-by commitments, even though this constitutes a questionable or improper accounting practice and even though such commitments entail major risks. (See, e.g., cases 4, 7, 13, 14, 21, 22, 25.)

Pricing, churning, unauthorized sales, delayed settlements. Certain salesmen and dealers have also engaged in other questionable sales practices in government related securities trading. In some cases dealers have charged excessive mark-ups and mark-downs or excessive and unexplained interest charges on customer accounts. And, at least in a few instances, dealers have engaged in churning of customer accounts, thereby inflating their own profits and commissions at the customers' expense. In other cases dealers and salesmen have carried out purchases and sales for customer accounts without customer authorization, sometimes utilizing false or misleading confirmations in the process. In at least one other case, it appears that the settlement dates on cash purchases of GNMAs by individual customers were delayed, which may have resulted

in customers losing one or two months of principal and interest payments on the securities they purchased. (See, e.g., cases 1, 4, 8, 9, 15, 18, 20, 21, 25.)

Disguising Losses and Overcommitments

After losses and over-commitments have been incurred in connection with government related securities trading, some dealers and investors have engaged in other transactions that, together with associated accounting practices, served to disguise either existing losses or the inability of an entity to carry out its contractual commitments. One practice used for these purposes is "adjusted trading" in which an investor, typically a financial institution, sells securities to a dealer at a price above the current market and agrees to purchase other securities at a similarly inflated price either concurrently with the sale or at a future date. The effect of these transactions is to inflate the book value of the investor's portfolio and similarly inflate its current earnings or reduce its reported losses. One bank and its holding company, for example, engaged in three types of "adjusted trading" in several varieties of government related and securities to hide substantial trading losses. These falsely reported transactions were made possible by the cooperation of a dealer bank and two other dealers. Savings and loans, credit unions, trust companies, banks, and even governmental entities have made use of transactions of this sort to hide a variety of losses. (See, e.g., cases 6, 10, 16, 21, 22.)

Repurchase agreements and reverse repurchase agreements 16/ of government related securities have also been used for the purposes of disguising losses or covering a purchaser's inability to pay for securities it had agreed to buy. Such arrangements have been especially common in connection with GNMA forward commitments that show substantial losses to the purchasers at the time of settlement. In a few instances, dealers have represented to their customers at the time they entered into forward contracts that they could relieve them of any potential losses at settlement by arranging repurchase or reverse repurchase transactions on favorable terms. (See, e.g., cases 4, 14, 21; cf. case 9).

Misuse of Customer Funds and Securities

Several of the cases in Appendix A reveal misuse by dealers of customer funds or securities in connection with the trading of government related securities. In some of these cases, unregistered dealers sold or hypothecated securities that

---

16/ See the discussion at pages 24-27, supra, explaining the nature and operation of repurchase and reverse repurchase agreements.

belonged to their customers or lenders, causing losses to the customers and lenders when the dealers became insolvent. In other cases, unregistered dealers have used newly received funds from investors to finance their commitments to purchase or repurchase securities from other investors. (See, e.g., cases 3, 7, 10, 13, 14, 17, 26).

In several other known cases, dealers have persuaded customers to enter into claimed "repurchase agreements" or other forward transactions in which there were actually no underlying securities. Accordingly, while denominated "repurchase agreements" or "standby with pair-off" trades, these transactions were in fact unsecured loans to the dealers. In some instances, these commitments were subsequently rolled-over and enlarged, all without any collateral being established. Two known cases involved the use of false confirmations to further convince the customers that the fictitious repurchase agreements or forwards were genuine. (See, e.g., cases 3, 10, 12, 13, 14).

Training and Supervision

Investigations in several cases have revealed serious inadequacies in the training and supervision of salesmen by dealers. In one case, an unregistered dealer developed a large business in government related securities using at least 15 salesmen with no prior experience in those securities. Nevertheless, the dealer firm provided no meaningful rules, guidelines, or training in fair and appropriate sales practices. What little instruction the firm did supply encouraged the salesmen to employ trading practices, such as churning of accounts, designed to inflate firm profits and salesmen's commissions at the expense of the customers. (See, e.g., cases 4, 7, 21).

Industry observers have indicated that major shortcomings in both training and firm supervision of sales practices have been chronic at some unregistered dealers. These shortcomings are especially serious where salesmen are given high commission rates and therefore have a heightened incentive to employ high-pressure sales methods and to make inadequate disclosure to customers. In fact, compensation to individual salesmen as high as 40% to 45% of the total firm commissions or markups on their sales have been utilized in government securities firms, and salesmen at certain firms have achieved extremely large earnings from these commissions. In the case cited in the preceding paragraph, at least 10 salesmen at an unregistered dealer each earned over $40,000 in net commissions during a single month. (See, e.g., cases 4, 10, 13, 15).

Recordkeeping

Finally, investigations of a number of dealers have revealed major shortcomings in recordkeeping. In various individual cases, dealer records have been so deficient as to (1) render impossible an assessment of a firm's financial position over substantial periods of time by an accounting firm subsequently retained by the firm's receiver; (2) make it impossible for a firm to calculate its own capital position; (3) fail to indicate whether a firm acted as principal or agent in certain customer purchases that were not completed because of defaults by the initial selling party; (4) leave doubt whether certain trades subsequently disclaimed by customers were in fact authorized or unauthorized; or (5) leave doubt as to whether or not a firm actually purchased the government related securities it had represented would underlie the investment packages it sold to investors. (See, e.g., cases 2, 7, 9, 12, 17, 20, 23).

Possible Regulatory Measures

The SEC and the SROs have applied various types of regulatory measures to reduce the incidence of trading abuses with respect to non-exempted securities. Although these requirements generally do not apply to government related securities, some dealers in such securities have implemented, on a voluntary basis, similar measures. Moreover, in the course of the interviews and discussions for this study, these and other measures have been suggested as desirable or appropriate in connection with the trading of government related securities. In the following pages we describe major categories of regulatory measures and their possible application to the markets for government related securities. These measures, if in place at the time, would have likely deterred or reduced the incidence of abuse outlined above, although these measures would of course not have totally eliminated fraud or deceit. 17/

Standards of Financial Responsibility

Standards of financial responsibility are imposed on registered brokers and dealers by the SEC, the Federal Reserve Board, and SROs. Their purposes are at least three-fold: (1) ensuring that brokers and dealers are financially sound and that they operate in such a way as to protect their assets and the funds and

17/ The following discussion is written in terms of applicability to "dealers," which term refers to both broker-dealers registered with the SEC pursuant to Section 15(b) of the 1934 Act and bank municipal securities dealers registered pursuant to Section 15B(a) of the 1934 Act ("bank dealers"). The rules applicable to municipal securities brokers and municipal securities dealers are established by the Municipal Securities Rulemaking Board (the "MSRB") and unless otherwise noted herein, are applicable to bank dealers. Some of the SEC's rules are also applicable to bank dealers in municipal securities. Certain aspects of regulation of bank dealers, as discussed herein, are performed by the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation (the "federal bank regulatory authorities").

securities held by them for customers; (2) preventing excessive use of credit for speculative purchases of securities and thereby promoting stability in the securities markets and in the nation's economy; and (3) protecting customers from becoming financially over-committed. 18/

Margins. Margin requirements establish a minimum amount of cash or securities that must be deposited or maintained as collateral in the purchase of securities on credit, or must be posted as deposits by parties to open contracts to ensure performance of their commitments. There are two types of margin: initial margin and maintenance margin. 19/ Initial margin requirements provide that the purchaser of securities must pay or deposit at least a certain percentage of the purchase price of the securities. 20/ Maintenance margin refers to the amount of money or securities required to be maintained in the account of a customer who has purchased securities on margin. Under these requirements, the amount of cash or securities collateralizing the loan or securing the commitment must be maintained at a certain level. 21/ As the market value of a security fluctuates, the dealer, for example, must "mark-to-market" the security and either credit the customer's account for the excess margin or require an additional maintenance margin payment. In the event the customer fails to respond to this "margin call" with an additional margin payment, the dealer is obligated to sell all or part of the collateral or the security and, after deducting any amount due the dealer, to remit any remaining proceeds of the sale to the customer.

18/ See, e.g., Don D. Anderson & Co. v. Securities and Exchange Commission, 423 F.2d 813, 816 (10th Cir. 1970) (net capital); S. Rep. No. 792, 73d Cong. 2d Sess. 3 (1934) (margin).

19/ Section 7 of the 1934 Act grants the Federal Reserve Board (the "FRB") the authority to set both initial and maintenance margin requirements for non-exempted securities. The FRB establishes initial margin requirements, but has chosen not to impose maintenance margin except with respect to options. See 12 CFR 220.8(j). It has issued the following regulations concerning margin: Credit by Brokers and Dealers (Regulation T), Credit by Banks for the Purpose of Purchasing or Carrying Registered Stock (Regulation U), Securities Credit by Persons Other Than Banks, Brokers, or Dealers (Regulation G), and Rules Governing Borrowers Who Obtain Securities Credit (Regulation X).

Municipal securities are exempted securities for the purposes of Section 7 and, therefore, bank dealers' transactions in municipal securities are not subject to the FRB margin rules.

20/ Regulation T allows broker-dealers to extend the allowable amount of credit on exchange-listed securities and certain securities traded over-the-counter (OTC margin securities). Broker-dealers cannot extend credit on OTC securities that are not OTC margin securities.

21/ Maintenance margin rules are set by exchanges and other self-regulatory organizations. See, e.g., Rule 431, NYSE Guide (CCH) ¶2431; Rule 12.3 CBOE Guide (CCH) ¶2373.

Net capital. The SEC's net capital rule establishes minimum amounts of liquidity that must be maintained by dealers registered with the SEC. 22/ It is designed primarily to ensure that firms have sufficient liquidity at all times to cover their current indebtedness to all customers, and are therefore able to satisfy customers' claims for cash or securities. The term "net capital" means net worth of a dealer (i.e.) assets less liabilities) less illiquid assets, and less a discount from the market value of the securities in the account of the dealer ("haircut"), plus certain subordinated liabilities.

Reserve, segregation, and hypothecation requirements. An SEC rule establishes reserve and segregation requirements for registered dealers which (1) limit the use of customers' funds by dealers in their business, and (2) require dealers to obtain and maintain physical possession or control of all fully paid and excess margin securities carried in the accounts of customers. 23/ The rule also requires a dealer to deposit that portion of the customer funds held by it and not used in connection with other customers' accounts in a special reserve bank account for the exclusive benefit of customers. 24/ A separate rule limits the circumstances under which dealers may hypothecate customer securities. 25/ These rules are designed to safeguard customers' funds and securities and prevent unsound use of customers' assets by ensuring that such funds and assets are deployed in safe areas of the broker-dealer's business.

Securities Investor Protection Corporation. In 1970, Congress established the Securities Investor Protection Corporation ("SIPC"). With certain limited exceptions, all brokers and dealers registered pursuant to Section 15(b) of the 1934 Act are required to be members of SIPC. In the event that the SEC or an SRO determines that a SIPC member subject to its regulation is in or approaching financial difficulty, it is required to notify SIPC immediately. If SIPC determines that the member has failed or is in danger of failing to meet its

---

22/ Rule 15c3-1; 17 CFR 240.15c3-1. The financial safety and soundness of federally chartered or federally insured bank dealers are subject to regulation by federal bank regulatory authorities; accordingly, bank dealers are not subject to the SEC's net capital requirements.

23/ Rule 15c3-3, 17 CFR 240.15c3-3.

24/ Rule 15c3-3(e), 17 CFR 240.15c3-3(e).

25/ Rule 8c-1, 17 CFR 240.8c-1.

obligations to customers, and certain other conditions exist, 26/ it may apply to federal court for a decree to appoint a trustee to distribute any customer cash and securities held by the member to the customers. A special SIPC fund supported by member assessments exists to allow prompt payment of these funds and securities, subject to certain dollar limitations.

Application to government-guaranteed securities. Of the various regulatory measures that have been proposed for the trading of government related securities, margin requirements for forward commitments in mortgage-backed securities seem to be the most needed. Two principal benefits could be expected from margin requirements in forward trading of such securities. First, depending on the details of the requirements, they would protect dealers and other forward market participants against losses should the parties with which they have contracted prove unable or unwilling to fulfill their commitments. Second, by requiring at least some initial commitment of capital and additional payments to cover unrealized losses from market movements, margin requirements would discourage overcommitments and lend added financial stability to all market participants.

Margin requirements would have precluded many of the overcommitment problems, discussed above, in forward trading of government related mortgage-backed securities. The vast majority of the serious over-commitments in this area have apparently resulted from the ability of investors to speculate without any initial cost, and to suffer increasing losses without having to make proportionate deposits.

Recognizing the probable efficacy of margin requirements in forward transactions respecting mortgage-backed securities, several major dealers have already begun voluntarily to demand margin payments from most customers entering into forward commitments with them. In addition, GNMA, PSA Self-Regulation, Inc., and the MBS Clearing Corporation have all implemented or proposed margin-related requirements and guidelines for forward trading. Likewise, there was near unanimity among the industry representatives, regulators, investors, and other persons interviewed that at least some form of maintenance margin requirements should be applied to forward trading in government related mortgage-backed securities. 27/

26/ These circumstances include non-compliance with applicable requirements under the 1934 Act, SEC rules, or rules of any SRO with respect to financial responsibility or hypothecation of customers securities. See Section 5(a)(2), Securities Investor Protection Act of 1970, 15 U.S.C. 78aaa5(a)(2).

27/ See, e.g., Rule 431(c)(2), NYSE Guide (CCH) ¶ 2431.

In this regard, however, several persons expressed the view that margin requirements should not be applied to mortgage bankers in the normal issuance process for GNMAs.

A number of technical questions will confront any attempt to impose margin requirements with respect to government related securities. These include (1) whether dealers should be required to post, as well as to demand, such payments with respect to their forward commitments; (2) whether exemptions should be recognized for commitments that are hedged in some manner; (3) if so, what sort of hedging should qualify, and what types of market participants should be able to take advantage of such exemptions; (4) in what forms will margin be allowed to be posted—cash, pledged securities, or letters of credit; (5) what entities should hold the margin payments for various classes of transactions; and (6) whether a clearing facility should be established to facilitate compliance with margin requirements. 28/ The successful application of mandatory margin requirements in other segments of the securities markets suggests that these questions can be resolved satisfactorily. In addition, the stock exchanges impose maintenance margin requirements on their members with respect to purchases of exempted securities on credit.

In addition to margin requirements, net capital and segregation requirements have been suggested for dealers. By requiring a conservative financial structure and full coverage of firm liabilities by qualifying assets, the net capital rule attempts to guarantee that subject dealers will be able to satisfy their customer obligations at all times. And, there seems to be little doubt that the net capital rule is reasonably effective in promoting the financial soundness and responsibility of dealers in non-exempted securities. Nevertheless, trading in government related securities is different in certain respects from trading in corporate securities. 29/ Accordingly, careful consideration is needed to determine what requirements in the area of net capital would be appropriate for dealers in government related securities.

Several of the cases described in Appendix A involved misuse by government securities dealers of customer funds or securities—e.g., selling or hypothecating customer securities or using customer funds in the dealer's operations. As applied to trading in non-exempted securities, requirements exist that seem to be reasonably

---

28/ See discussion in chapter VI, *infra*.

29/ For example, the characteristics of government securities trading may make it possible for dealers to hedge their commitments effectively in ways that are not effective or reliable for other types of securities.

effective in protecting customer-owned assets. Reserve and segregation requirements could be devised that would provide increased protection for customer-owned assets held by government related securities dealers. In one of the cases described in Appendix A, such requirements were applied with respect to customers' government related securities accounts and played a substantial role in preventing customer losses despite the dealer's insolvency. (See case 7.)

It may also be appropriate to require non-bank government securities dealers to join SIPC. Such a requirement would protect smaller investors from losses occasioned by dealer insolvencies 30/ and help to preclude any loss of public confidence in the government related securities markets. The costs of SIPC membership represent a sharing by securities dealers of the risk of investor injury, and are now relatively small. 31/

Standards of Fair Practice

Many investors deal with securities dealers from a position of unequal knowledge and understanding of relevant investment information. To protect investors from overreaching and unfair practices by dealers, the SEC and the SROs have prescribed several categories of "fair practice" rules, which generally require dealers to treat investors in accordance with "just and equitable principles of trade." 32/

Confirmations and disclosure. Several "fair practice" rules require dealers to disclose to investors information important to an understanding of their securities transactions. For example, SEC and SRO rules require confirmations of transactions, including those in exempted securities, to be sent to customers on or before settlement of a transaction disclosing, among other things, the price and identity of the securities bought or sold, the dealer's capacity (principal or agent) in the transaction, and the commissions charged by the dealer when acting

---

30/ It is important to note, however, that SIPC ensures only $100,000 in securities claims, including up to $40,000 in cash per customer at a member firm. Government related securities transactions frequently involve amounts much greater than this. SIPC is supporting the introduction of legislation which would raise the amount of coverage to $500,000, including up to $100,000 in cash. S. 1076, 96th Cong., 2d Sess. (1980).

31/ Each SIPC member was required to pay an assessment equal to one-eighth of one percent of its gross securities revenues at the time the SIPC fund was established. The SIPC fund currently approximates $190,000,000 and is supported by assessments on members not to exceed $150 per annum.

32/ See, e.g., Rules of Fair Practice, Article III, Section 1, NASD Manual (CCH) ¶ 2151.

in an agency capacity. 33/ Such requirements protect investors by providing them with disclosure of the terms on which their money and securities are being handled and the charges they are incurring. They also protect both dealers and investors by minimizing the chances of repeated unauthorized trades and creating a record the parties can refer to in case of subsequent disagreements. Other SEC and SRO rules serving similar investor protection purposes require dealers to disclose interest rates in credit arrangements; 34/ and to disseminate to customers audited balance sheets reflecting the dealer's financial condition 35/ and account statements showing a customer's security and money positions. 36/

Suitability. Suitability rules seek to protect both the customer and the dealer by discouraging customer transactions that are inappropriate in view of the customer's financial situation and investment objectives. Such rules typically prohibit dealers from recommending, and in some cases executing, 37/ securities transactions unless the dealer reasonably believes that the transaction is suitable for the customer in light of a customer's financial resources, investment objectives and needs. One SRO rule requires the subject dealers to make suitability determinations upon the basis of relevant information, if any, proffered by a customer. 38/ Stricter rules impose an affirmative duty on dealers to inquire into the investment objectives and financial situation of customers before making a suitability determination. 39/ Perhaps the most stringent SRO suitability rule forbids subject dealers from recommending a transaction unless they reasonably believe that the customer, in addition to being financially suited to the transaction, has sufficient knowledge and experience in financial matters to evaluate the risks of the transaction. 40/

33/ See Rule 10b-10, 17 CFR 240.10b-10; Rules of Fair Practice, Art. III, Sec. 12 NASD Manual (CCH) ¶ 2162; Rule 9.11, CBOE Guide (CCH) ¶ 2311. See Rule G-15, MSRB Manual (CCH) ¶ 3571, for more detailed confirmation requirements.

34/ See Rule 10b-16, 17 CFR 240.10b-16. Bank dealers which extend credit are subject to the disclosure provisions of the Truth-in-Lending Act, 15 U.S.C. 1601 et seq.

35/ See Rule 17a-5, 17 CFR 240.17a-5; Rule 9.13, CBOE Guide (CCH) ¶2313. Bank dealers are subject to the reporting requirements of the federal bank regulatory agencies.

36/ See Rule 9.12, CBOE Guide (CCH) ¶ 2312.

37/ See Rule 15c2-5, 17 CFR 240.15c2-5.

38/ See Rules of Fair Practice, Art. III, Sec. 2, NASD Manual (CCH) ¶ 2152.

39/ See Rule 15b10-3, 17 CFR 240.15b10-3; Rule 15c2-5, 17 CFR 240.15c2-5; Rule 9.9, CBOE Guide (CCH) ¶ 2309; Rule G-19, MSRB Manual (CCH) ¶ 3591.

40/ See Rule 9.9, CBOE Guide ¶ 2309.

Closely allied to suitability rules are "know your customer" rules, which affirmatively require dealers to inquire about facts such as a customer's occupation, investment objectives, and financial situation, i.e., information relevant to a suitability determination. 41/ In addition to serving as a fundamental protection for customers who rely on the judgment and expertise of dealers, "know your customer" rules provide protection to dealers who might otherwise execute transactions for customers financially unable to fulfill their contractual obligations.

Fair pricing. To ensure that customers are not charged excessive prices or brokerage commissions, SROs have prescribed rules that require dealers, when acting as principals, to buy from or sell to customers at fair prices; and when acting as agents, to charge customers fair commissions. 42/ Fair prices and commissions are determined by factors such as market conditions at the time of the transaction, the total amount of the transaction, expenses involved in effecting or executing the transaction, the value of the services rendered, and the dealer's best judgment of the fair market value of the traded securities at the time of the transaction.

Trading authorization and churning. Another important objective of the fair practice rules is to ensure that dealers do not execute trades for customer accounts outside the scope of the authority given by the customer. Accordingly, SRO rules (1) prohibit dealers from exercising any discretionary trading power in a customer's account without prior written authorization from the customer, 43/ (2) require that supervisory persons approve in writing discretionary account transactions, 44/ (3) mandate frequent review of discretionary accounts to prevent irregularities and abuses, 45/ and (4) require the recording of all purchase and sale orders, regardless of execution. 46/ In addition, SEC and SRO rules

---

41/ See Rule 15b10-6, 17 CFR 240.15b10-6; Rule 9.7(b), CBOE Guide (CCH) ¶ 2307; Rule 405, 2 NYSE Guide (CCH) ¶ 2405. Bank dealers are subject to the suitability rules of the MSRB, which include similiar provisions.

42/ See Rules of Fair Practice, Art. III, Sec. 4, NASD Manual (CCH) ¶ 2154; Rule G-30, MSRB Manual (CCH) ¶ 3646.

43/ Rules of Fair Practice, Art. III, Sec. 15, NASD Manual (CCH) ¶2165; Rule G-26, MSRB Manual (CCH) ¶ 3626; Rule 9.10(a), CBOE Guide (CCH) ¶ 2310.

44/ See Rule G-26(c), MSRB Manual (CCH) ¶ 3676.

45/ Id.

46/ See Rule 15c1-7, 17 CFR 240.15c1-7; Rules of Fair Practice, Art. III, Sec. 15, NASD Manual (CCH) ¶ 2165; Rule G-19(b), MSRB Manual (CCH) ¶ 3591; Rule 9.10(c) CBOE Guide (CCH) ¶ 2310.

expressly prohibit dealers from churning customer accounts, i.e., from causing trading activity that is excessive in size or frequency in view of the financial resources and character of a customer's account. 47/

<u>Application to government related securities</u>. Next to rules on financial responsibility, rules of fair practice could well be the most important to reduce the incidence of abuses in the market for government related securities. Although much of the trading volume in this market still consists of transactions between large sophisticated institutions, small less sophisticated investors are now participating in the forward markets for mortgage-backed securities. These investors stand at a significant informational disadvantage relative to securities professionals and are in the greatest need of effective "fair practice" protections.

If effectively enforced in government related securities trading, "fair practice" rules like those applicable to non-exempted securities probably could have deterred or reduced the incidence of many of the trading abuses discussed in Appendix A. Of course it is impossible to eliminate, by rule, every possibility of abuse. But a number of these rules proscribe, in relatively specific terms, the precise abuses that have arisen in a number of cases. Consistent with this view, industry representatives seem to favor extension of "fair practice" precepts to the government related markets. The leading association of dealers in mortgage-backed securities has approved certain "fair practice" rules for trading by its members. In addition, a number of government securities dealers, including several of the largest dealers which deal with many of the most sophisticated institutional customers, have already implemented, on a voluntary basis, guidelines, mechanisms, or procedures that resemble some of the principal "fair practice" rules.

Suitability rules, in particular, would address an important problem area in the trading of government related securities. There are a number of instances when small institutions and individuals have engaged in unsuitable transactions in government related securities. Any kind of significant suitability and know your customer requirements, especially if implemented with procedures such as credit checks, would have prevented some of these problems. Moreover, the great majority of industry representatives we spoke with, as well as most of the governmental agencies, believe that appropriate suitability rules

---

47/ See Rule 17a-3, 17 CFR 240.17a-3 Rules of Fair Practice, Art. III, Sec. 21, NASD Manual (CCH) ¶ 2171; Rule G-8, MSRB Manual (CCH) ¶ 3536.

can be formulated and should be applied to trading in government related mortgage-backed securities. The leading association of mortgage-backed securities dealers has proposed specific suitability requirements, and several dealers in such securities have implemented suitability requirements on their own initiative. 48/

Standards of Competency and Integrity and Supervision Requirements

Competency and qualifications. To ensure that investors are served by competent and honest securities professionals, SEC and SRO rules prescribe minimum competency requirements for securities dealers. These rules require certain employees of dealers to pass minimum competency examinations before being deemed qualified for employment. 49/ In addition, some SROs require the principals of dealer firms to pass a specific examination to assure that they are sufficiently competent to handle supervisory responsibilities, 50/ and require securities salesmen to complete training courses 51/ and apprenticeships 52/ before transacting business with the public.

Integrity and disqualification. To promote integrity among securities dealers, SEC and SRO rules prescribe disqualification procedures for dealers and their associated persons who have been expelled or suspended from SRO membership, have willfully violated any provisions of the securities laws, or have committed other enumerated infractions. 53/ Hiring and termination procedures prescribed for registered dealers are designed to identify dishonest salesmen by requiring hiring firms to make inquiries into the previous employment records and reputations of prospective employees 54/ and to file notices with SROs when salespersons leave, specifying the reasons for departure and disclosing whether the salespersons were the subject of any major complaints. 55/

48/ We note, however, that formulation and application of suitability rules with respect to institutional investors, which constitute a large percentage of the purchasers of government related securities, can raise issues not generally encountered with respect to suitability rules respecting individual investors.

49/ See Rule 15b8-1, 17 CFR 240.15b8-1; Rule G-3, MSRB Manual (CCH) ¶ 3511; Rule 9.3, CBOE Guide (CCH) ¶ 2303. Rule 345.15, 2 NYSE Guide (CCH) ¶ 2345.

50/ See Rule G-3(d), MSRB Manual (CCH) ¶ 3511; Schedule C, Details of Qualification Examination, NASD Manual ¶ 1102A.

51/ See Rule 9.3, CBOE Guide (CCH) ¶ 2302; Rule 345.15, 2 NYSE Guide (CCH) ¶ 2345.

52/ See Rule G-3(h), MSRB Manual (CCH) ¶ 3511.

53/ See Sections 3(a)(39), 15(b)(4), 15(b)(6), 15B(a)(2), 15B(c)(2) of the 1934 Act; Rule 15b8-2, 17 CFR 240.15b8-2; Rule 345(d), 2 NYSE Guide (CCH) ¶ 2345; Rule G-4, MSRB Manual (CCH) ¶ 3516.

54/ See Rule 345.18, 2 NYSE Guide (CCH) ¶ 2345; Rules of Fair Practice Art. III, Sec. 27, NASD Manual (CCH) ¶2177.

55/ See Rule 345.13, 2 NYSE Guide (CCH) ¶ 2345; Rule 9.3, CBOE Guide (CCH) ¶ 2303.

Supervision. Strict supervisory rules have also been prescribed to assure that sales personnel and other associated persons of dealers perform their duties without violating the securities laws or SRO standards of conduct. These rules typically require dealers (a) to appoint firm officials to supervise the securities activities of all persons associated with the firm; (b) to establish, maintain, and enforce written procedures to assure compliance with broker-dealer supervisory responsibilities; and (c) to designate a firm official to review supervisory activities of supervisors and inspect each business office of the dealer to ensure that the written procedures are enforced. 56/

Application to government related securities. As indicated above, there have been several notable examples of incompetence and dishonesty on the part of certain dealers in government related securities, and equally notable examples of inadequate training and supervision of salesmen by such firms. Implementation of meaningful standards of training, qualification, and supervision would discourage situations in which major departures from reasonable standards are widespread within a firm and are continuing in nature. In addition, state securities regulators and other persons familiar with past abuses in municipal securities trading have emphasized that a number of past violators in the now-regulated municipal securities area are currently active in government related securities. Accordingly, employee reviews, background checks, and other mechanisms to identify persons previously disqualified from associating with dealers would be helpful in improving the integrity of the trading markets in government related securities.

Of course, the majority of government securities dealers now appear to be observing reasonable standards of competence, training, and supervision on a voluntary basis. Likewise, the leading association of mortgage-backed securities dealers has proposed rules which are designed to improve training and supervision requirements for its members. 57/ Because of its concern with abuses in the markets for mortgage-backed securities, GNMA supports the imposition of competency, integrity, and supervision standards; and so do the regulatory authorities interviewed for this study. Nevertheless, no formal rules in this area legally bind firms dealing exclusively in government related securities, and the presence of even a relatively small group of less capable and less scrupulous firms and salesmen in the industry poses a potential threat to less sophisticated individual and small institutional investors.

56/ See Rule 15b10-4, 17 CFR 240.15b10-4; Rules of Fair Practice, Art. III, Sec. 27, NASD Manual (CCH) ¶ 2177; Rule G-27, MSRB Guide (CCH) ¶ 3631; See Rules 342 and 405, 2 NYSE Guide (CCH) ¶¶ 2342, 2405, and Rule 9.8 CBOE Guide (CCH) ¶ 2308, for much briefer supervisory rules.

57/ See Chapter V, infra.

Dealer Registration

Securities dealers may not engage in an interstate business in nonexempted securities or be members of SROs without complying with the SEC's registration requirements. 58/ Initially, these requirements serve to implement the qualification requirements and serve an important identification function since, prior to registration with the SEC or joining an SRO, a dealer must file an application disclosing specific information, 59/ and must meet prescribed standards of competence, operational capability and financial responsibility. 60/ Thereafter, the registration requirements allow the SEC and SROs to monitor broker-dealer compliance with the applicable regulatory requirements, including the bookkeeping and record-keeping provisions, 61/ the rules calling for the filing of periodic financial reports, 62/ and the financial responsibility rules. Registration requirements also play an important role in connection with the SEC's statutory disqualification authority and rules, which provide for the denial or revocation of a dealer's registration for failure to comply with SEC or SRO rules and standards. 63/

Application to government related securities. Mandatory government securities dealer registration is an essential condition for assuring compliance with most of the regulatory measures that might be applied to trading of government related securities. Without mandatory registration, regulatory authorities would encounter great difficulties in keeping track of dealers and in developing systems to monitor and ensure compliance. A number of the industry experts interviewed in connection with this study expressly indicated the desirability of universal registration requirements for dealers in government related mortgage-backed securities. In addition, absent such requirements, new means would have to be developed to implement standards of competence and integrity and to impose disciplinary sanctions if these measures were imposed on dealers in these securities. There is no assurance that such new means would be as efficient or effective as the systems based on mandatory registration.

58/ See Section 15(a)(1), and Section 15B(a)(1) of the 1934 Act. See also Sections 6(c)(1), and 15A(g)(1) of the 1934 Act.

59/ See Rule 15b1-1, 17 CFR 240.15b1-1; Rule 345.11, 2 NYSE Guide (CCH) ¶ 2345; Rule 9.3, CBOE Guide (CCH) ¶ 2302. See also Rule 15Ba2-1, 17 CFR 240.15Ba2-1 (bank dealer registration).

60/ Rule 15b8-1, 17 CFR 240.15b8-1; Rule G-3, MSRB Guide (CCH) ¶ 3511.

61/ See note 69 & accompanying text infra.

62/ See notes 70-71 & accompanying text infra.

63/ See Sections 15(b)(1), 15(b)(4), and 15B(a)((2) and (c)(2) of the 1934 Act; cf. Sections 3(a)(39), 6(1)93)A, 15A(g)(3)(a), and 19(h) of the Act; Rule 15b8-2, 17 CFR 240.15b8-2; Rule 345, 2 NYSE Guide (CCH) ¶ 2345.

Books and Records

SEC and SRO rules require registered dealers to maintain accurate books and records on, among other things, all purchases and sales of securities; copies of confirmations of all purchases and sales; all assets and liabilities of a firm; cash and margin accounts of customers; securities in transfer; dividends and interest received; securities and money borrowed and loaned; securities not received or delivered; long and short positions in securities; brokerage orders and instructions for purchases and sales (regardless of execution); repurchase agreements; employment questionaires for associated individuals; and customer complaints. 64/ Related rules and statutory provisions also require dealers to designate a firm official to assure maintenance and preservation of records, 65/ and provide for the right of inspection by an SRO or the SEC at any reasonable time. 66/

Application to government related securities. As indicated above, serious deficiencies in recordkeeping practices have been evident in some of the recent cases described, and these deficiencies made it difficult for the firms to assess accurately their own capital positions or to guide their business operations. Appropriate recordkeeping would obviously have prevented problems due to these deficiencies. Moreover, enforcement of most of the regulatory measures discussed above (e.g., margin, net capital) would require the maintenance of at least some standardized types of records.

Reporting, Compliance, and Enforcement

A variety of mechanisms have been developed to achieve a high level of compliance with the regulatory measures applicable to registered securities dealers.

Reporting and early warning systems. To find violations of financial responsibility and other related rules at an early stage, the SEC has developed a reporting and early warning system based largely on mandatory reporting by dealers. The reporting and early warning system ensures that current information on each dealer is available to the SEC and provides a mechanism for SEC action in the event a dealer fails to conform to the rules.

64/ See Rule 17a-3, 17 CFR 240.17a-3 Rules of Fair Practice, Art. III, Sec. 21, NASD Manual (CCH) ¶ 2171; Rule G-8, MSRB Manual (CCH) ¶ 3536.

65/ See Rule G-10, MSRB Manual (CCH) ¶ 3546.

66/ See Section 17(a) of the 1934 Act; Rule G-9, MSRB Manual (CCH) ¶ 3541. Inspection of bank dealers is done by the federal bank regulatory authorities.

Dealers that carry customer accounts are required to prepare reports monthly, quarterly, and annually and to file them with the SEC. 67/ The annual reports must be certified by an independent public accountant and must be furnished to all customers. 68/ In addition, when a dealer fails to comply with the SEC's reserve and segregation requirements or net capital rule or fails to keep its books and records current according to the SEC's recordkeeping rule, the dealer must provide immediate notice to the SEC, and must file special reports with the SEC for a specified period of time, 69/ until it demonstrates its ability to comply with applicable rules.

Compliance: Inspections, disciplinary proceedings, oversight, and enforcement. Aside from the reporting and early warning systems, the task of ensuring compliance with the rules applicable to registered brokers and dealers is performed by a two-tiered system in which (1) the SROs are delegated governmental-type powers and responsibilities to enforce compliance by their respective members, and (2) the SEC performs both an oversight role to ensure that the SROs carry out their responsibilities effectively and fairly, and a supplemental enforcement role.

SROs seek to enforce compliance with the federal securities laws and their own rules primarily through inspections and disciplinary proceedings. SRO rules and procedures provide for inspection of all members within certain time periods. 70/ A system of market surveillance operated by the SROs supplements these inspections. Disciplinary sanctions are imposed on members or persons associated with members by SROs for violations of the 1934 Act or SEC or SRO rules. 71/

67/ Rule 17a-5(a), 17 CFR 240.17a-5(a). Bank dealers are not subject to these reporting requirements.

68/ Rule 17a-5(c), 17 CFR 240.17a-5(c).

69/ Rule 17a-11, 17 CFR 17a-11. The rule also requires a self-regulatory organization to give immediate notice to the SEC in the event it discovers a violation of any of the rules by a member.

70/ See, e.g., MSRB Rule G-16 (requires inspection of municipal securities brokers and municipal securities dealers once every two years).

71/ An SROs sanctions may include, for example, censure, suspension of up to five years, expulsion, or fines of up to $25,000 for a member or $100,000 for a member firm.

The SEC, in its oversight role, reviews the performance of the SROs through oversight inspections of member firms and of the SROs themselves. The SEC itself also inspects firms registered with the SEC that are not members of an SRO. Under the 1934 Act, inspection and compliance authority for bank dealers is allocated to the federal bank regulatory agencies. The SEC also has the authority to inspect these entities, after notice and consultation with the appropriate regulatory agency. Finally, the SEC has administrative enforcement authority over all persons registered with it 72/ and may institute injunctive actions in the federal courts to enforce compliance with the securities laws by persons not so registered.

Application to government related securities. A number of the cases described in Appendix A involved widespread and continuing abuses that may have been caught by inspections or possibly prevented if the entities had been subject to a regulatory program and had been inspected, although some abuses would no doubt persist under any possible compliance system. Reporting and early warning are particularly efficient mechanisms for monitoring and encouraging compliance with those financial and operating requirements that, in themselves, require regulated firms to perform analyses and tabulations of internal information. Audit requirements help assure that books, records, and reports are accurate. Inspections not only provide further assurance of such accuracy but also furnish a principal method of encouraging and monitoring compliance with a broad range of substantive requirements.

The existing reporting, compliance, and enforcement system for registered dealers seems to be reasonably effective. Its flexibility, moreover, has recently been demonstrated by the application of this system to the municipal securities markets. Absent some measures analogous to those employed in this existing system, there would seem to be no assurance that any substantive regulatory requirements that might be imposed on the trading of government related securities would actually be followed.

72/ This includes broker-dealers, municipal securities dealers, registered securities information processors, and SROs.

APPENDIX

SEC INVESTIGATIONS OF CASES OF ABUSIVE TRADING PRACTICES

The following factual accounts, based upon the results of actual lawsuits, investigations, and inquiries, present examples of problems and abuses in the trading of government and government related securities. Although we believe that the accounts accurately present the major facets of the respective cases, particular facts in some of the cases may be subject to dispute. The names of parties and other identifying characteristics in the cases have been omitted to prevent the disclosure of nonpublic or sensitive information.

Case # 1

In this early administrative proceeding, unsuitable transactions were entered into by a large registered broker-dealer for the account of a major public university. The broker-dealer also churned the account and failed to reflect the account's transactions properly on its books and records.

The subject transactions involved government securities, including forward commitments executed in 1974 to purchase GNMAs. The university had sought low risk investments for its investment account of approximately $1.5 million. Nevertheless, its account acquired commitments exceeding $3 million, and sustained losses of nearly $1 million.

These unsuitable trades had been handled by only one of the broker-dealer's registered representatives. The SEC brought an administrative proceeding against the broker-dealer and accepted a settlement which included findings of a failure to supervise the registered representative involved. In addition, the broker-dealer agreed to take remedial steps to prevent recurrence of these activities, including written approval of manager prior to execution of GNMA forward commitments in excess of specified amount and the institution of procedures for the early detection of excessive trading activity by account executives. The registered broker-dealer reached a settlement with the university in which it agreed to share the losses that had been sustained and pay approximately $400,000 to the university, resulting in a net loss to the university of approximately $600,000.

Case #2

B Corporation was an unregistered dealer in government-issued and government guaranteed securities with offices in the Midwest and in New York City. B engaged in repurchase agreements and reverse repurchase agreements with respect to these securities with various entities, including corporations, banks, and state and local governments. B filed a voluntary petition of bankruptcy in late-1975.

B accumulated a portfolio of well over a billion dollars worth of securities, primarily Treasury securities, by buying the securities and immediately putting them out on repurchase agreements during a period when repo rates were lower than the rates on government securities. As long as the rate of return on the securities exceeded B's cost of financing the purchase of the securities, B profited on the arbitrage between the two rates, and used these profits to build an extensive pyramid of government securities. When interest rates unexpectedly rose, however, causing the cost of borrowing to rise and the market price of B's government securities inventory to drop, B experienced severe financial problems. During a two-week period in mid-1975, B defaulted on several repurchase agreements. Although B was insolvent during this period, it continued to operate, and entered into at least one additional repurchase agreement.

B's financial problems were exacerbated by its failure to maintain complete and accurate books and records. Its recordkeeping relied in large part on uncorrelated purchase and sales confirmations, some of which were maintained in chronological order while others were ordered according to other systems. Accordingly, these confirmations provided no useful system for checking daily transactions. Further, B's logs of transactions failed to reflect accurately all of its securities transactions, and, for its final year of operations, B failed to maintain various journals and ledgers.

Although B did large amounts of business with its major customers, it failed on several occasions to honor their requests for its financial statements. These financials would have revealed the company's precarious position. Moreover, when B turned its books and records over to a bankruptcy receiver, these documents were so incomplete and disorganized that the receiver had to engage an accounting firm to attempt to determine B's position with regard to its open repurchase and reverse repurchase agreements. The books were in such bad condition, however, that the accountant was unable to express an opinion on the company's financial condition for any period during 1975.

Papers filed in the bankruptcy proceedings indicate that B's liabilities exceeded its assets by $19 million. While the total amount of losses resulting from B's defaults is not known, two repo customers reported losses totalling $2.4 - 2.8 million.

Case # 3

G was incorporated in 1973 and shortly thereafter began doing business as an unregistered broker-dealer in government and municipal securities. G ceased its municipal securities business in 1975 when the Securities Acts Amendments of 1975 became effective, thereby requiring registration with the SEC of municipal securities broker-dealers. From 1975 through 1977, G engaged in the purchase and sale of securities issued by the U.S. Treasury, and sponsored federal agencies, and mortgage-backed securities guaranteed by GNMA.

In early 1976, G began selling GNMA certificates and Treasury securities under agreements to repurchase. Over the course of the next eighteen months, G solicited and entered into 27 separate fraudulent repo transactions, generally with small banks and savings and loan associations. It solicited customers by representing that it was acting as agent for a bank, and would pay interest generally 1% higher than the prevailing federal funds rate. Customers were assured that the investment was sound because it was guaranteed by the federal government.

G instructed customers to wire funds to several banks at which G had accounts. No securities were ever delivered to customers; rather, customers were told that they would be sent safekeeping receipts indicating that the securities purchased were deposited in third party banks. No such receipts were ever received by customers. In fact, G's own records indicate that it never owned or acquired the securities covered by the repo transactions.

Generally, when repo transactions fell due, G would engage in various practices to delay as long as possible the repurchasing of the securities. For example, it would: (1) issue confirmations extending the repo date without authorization, (2) claim that a foul-up in the wire transfer procedure had delayed repayment, or (3) write checks it knew would be returned for insufficient funds.

These practices resulted in G's failure to meet repurchase obligations totalling over $1 million.

Case #4

H, an unregistered broker-dealer involved exclusively in trading government-guaranteed and government-issued securities from its inception in 1974 until mid-1977 when it ceased doing business, was a wholly owned subsidiary of a registered broker-dealer that went out of business as a result of net capital problems attributable to the unregistered dealer.

More than 60% of H's business involved forward transactions in GNMA mortgage-backed securities with national and state banks, credit unions, and savings and loan associations. The balance of its business was in other government securities. H employed approximately 30 salesmen who were given territorial areas throughout the country in which to solicit institutional customers over the telephone.

H had tremendous success in late 1976 when GNMA prices were steadily rising, carrying approximately 250 accounts and often trading over $50 million a day. The firm's profit for December, 1976, was $1.7 million, and during that single month 10 of the salesmen each earned net commissions of over $40,000.

In early 1977, however, GNMA prices turned downward. At that time H's customers were committed to purchase GNMA securities totalling more than $400 million from the firm, with settlement dates through the first half of 1977. When certain customers disclaimed these transactions, H had to sell their securities at a loss, leaving its customers still owing $8.1 million on their commitments and leaving H short approximately $4 million on its commitments to dealers. H instituted, or planned to institute, law suits against 31 institutional customers who had disclaimed transactions, but most of the customers disclaiming transactions alleged that H engaged in unauthorized transactions or had misrepresented or omitted material information concerning the risks attendant to GNMA forward trading. In addition, some customers indicated that the individuals with whom the salesmen had dealt lacked authority to bind the institutions. Four suits were also filed against H alleging violations of the securities laws and common law fraud.

In the following three months, representatives of the dealers to whom H owed money attempted to work out a plan to permit H to continue operating, under certain restrictions, in an effort to reduce the outstanding indebtedness. H, however, was unable to generate sufficient business to meet its overhead. It ceased doing business in mid-1977, leaving $4 million owing to its customers and dealers.

There appear to have been numerous causes of the aforementioned problems including principally agressive sales practices which led to customers becoming over-committed in connection with GNMA forward transactions, and then refusing to take delivery when interest rates rose. H failed to train its salesmen or to exercise any meaningful supervision or control over them. Of the salesmen employed by H, at least 15 had either no experience in the sale of government securities or experience limited to municipal securities. Despite this lack of of experience, H established no rules or guidelines concerning suitability, trade authorization, or the mark-ups, mark-downs, or spreads charged on transactions. Salesmen were permitted to engage in transactions of any size without authorization from principals. While one of the principals conducted a "training program," it laid little stress on trading procedures and regulation, but emphasized (1) that customers were not required to commit any capital at the time they purchased GNMA commitments and (2) that the firm was therefore justified in reducing customer profits and keeping as much profit as possible for itself. Supervisors also impressed upon salesmen that they could earn commissions only only by causing active trading in their customers' accounts. The relatively high 40% commission rate obviously contributed to the salesmen's incentives to engage in excessive trading.

As a general practice, the salesmen used high-pressure, "boiler-room" sales techniques in soliciting customers, and misstated and omitted to state many material facts in connection with these solicitations. Using aggressive and persistent presentations in telephone contacts with banks, savings & loans, and credit unions, the salesmen emphasized that quick profits could be made in trading GNMAs and that such profits could be made without risk and without committing funds, because no margin was required. In some cases they told customers that delivery would not have to be taken because the securities could be sold at a profit prior to delivery. Customers were also told that, in the event delivery had to be taken, H would arrange reverse repurchase agreements as a means of extending credit. In this manner, customers who could not afford to accept delivery of GNMA securities were induced to trade in such contracts without being informed of the risks inherent in reverse repo agreements. Indicative of the resulting over-commitments, one credit union with total assets of under $1 million was committed to purchase $5 million worth of securities, and a bank with $11 million in total assets was committed to purchase $21 million in securities.

Once a customer had purchased commitments for GNMA's, the salesman would seek authorization to commence trading on a discretionary basis for the customer's account. Even where authorization was not received, salesmen nevertheless sometimes bought and sold GNMA securities for the customer's account and then, in an effort to obtain such authorization, sent confirmations, or "wooden tickets," notifying the customer of its profit.

In the rising market that existed during the final quarter of 1976, the salesmen engaged in trading practices that enabled them and the firm to make enormous profits while reducing customers' profits. The fact that the customers were continuously realizing profits apparently prevented them from discovering these unconscionable practices. For example, notwithstanding the rising market, the salesmen frequently repurchased customer commitments as soon as there was a small profit in an account, e.g., 1/32 or 2/32 of a point, and then had the firm resell the commitment to another customer. Some of these repurchases were effected without authorization, while in other cases the firm had apparently convinced the customers to give it trading discretion. The salesmen generated enormous profits by engaging in excessive mark-up and mark-down practices in connection with these riskless principal transactions. For instance, a salesman would obtain the price at which H could sell a security to a third party and then determine the price it would pay its customer for the security, often making the purchase at a price substantially below the market.

Finally, the salesmen in some cases allowed, or even encouraged, the opening of "sham" accounts, where individuals acting under the guise of an institution or corporation traded GNMA securities for their own accounts. For example, one salesman persuaded two individuals with limited means to form corporations to trade GNMAs. These individuals traded over $185 million of GNMA securities, resulting in substantial losses.

Case # 5

"I" was formerly an office manager for a large registered broker-dealer. J and K were registered representatives in the same office. I, J and K also owned one corporation and one partnership that traded in government securities.

Using information obtained from the broker-dealer, I, J, and K schemed to interposition their corporation between the registered broker-dealer and outside broker-dealers to make profits in government securities trades. They concealed this from the broker-dealer by the use of the government bond trading department of a large national bank. Beginning in late 1973, J arranged for the corporation to open a bank account and bond trading account at the national bank. All contacts with the bank were made through one of its vice presidents, who worked in its government bond trading department. This vice president was a long-time friend of J. For 2 1/2 years thereafter, numerous trades of government bonds were carried out among the broker-dealer, the interpositioned corporation, the bank's bond department, and outside parties.

J, who did most of the government securities business in the broker-dealer's office, determined each morning at what prices the broker-dealer's government bond traders in New York would sell certain bonds and related this information to I, K and the bank's vice-president. With this information and the aid of the bank's vice president, purchase prices were obtained from outside dealers. The bank's vice president, with I, J, and K, would then cause the bank to place orders through the broker-dealer to buy bonds at prices at which the broker-dealer was willing to sell. Once the trade was made, the vice president would execute a sale to an interpositioned corporation at or near the purchase price from the broker-dealer. Simultaneously, the vice president would execute another trade with the corporation buying the government securities back at a higher price. He would then sell the bonds out to the outside dealers.

Thus, profits which, but for the interpositioning, would have gone to the broker-dealer or to outside purchasers were diverted through the bank's bond department to companies owned by I, J, and K. These three men also made commissions from the broker-dealer on the orders of bonds the bank placed through them. In a two and one-half year period, I, J, and K made over 130 interpositioned trades and over $268,000 in profits

When the scheme was discovered in mid-1976, I and the vice president were fired. J and K also left the broker-dealer in mid-1976.

In 1977, the SEC instituted an administrative proceeding against I, J and K. In a subsequent settlement, I and J were barred from association with any broker or dealer, and K was suspended for three months from any association with any broker or dealer and received a further nine months suspension from any association other than in a supervised capacity. No administrative action could be taken against the bank vice president.

Case #6

N Corporation was a holding company which owned four banking subsidiaries and had a class of securities that were registered with the SEC pursuant to Section 12(g) of the Securities Exchange Act. Bank M, the largest of these subsidiaries, failed in October, 1975. Bank M accounted for most of the assets of N Corporation, and its failure led to the collapse of N as well.

In early 1973, in an effort to avoid recognizing an $805,000 loss suffered in connection with short sales of government securities, M engaged in "adjusted trading" of U.S. Treasury and government-guaranteed securities. Adjusted trading is the practice of pairing purchases and sales of securities at a price in excess of the current market price.

Three basic methods of adjusted trading were employed. First, the bank sold securities to a registered broker-dealer at prices from three to four points above the market and subject to oral repurchase agreements. The bank repurchased these securities at similarly inflated prices in the following month. The bank treated these transactions as outright sales and separate purchases of securities.

The bank's second method of adjusted trading was bond swaps, in which the bank would sell securities to a dealer at the current market price plus a one to four point premium and, later the same day, purchase different securities from the same dealer at the market price plus the same one to four point premium. Bank M engaged in these swaps with both a large national bank and a second registered broker-dealer. The national bank had established no staff guidelines on adjusted trading and allowed trades to take place at premiums of three to four points over the market. The registered broker-dealer also permitted adjusted trading, although supervisory personnel within the broker-dealer prohibited premiums of any more than about one point over market, which approximated a day's range of trading. As a result of these swaps, Bank M avoided showing losses of over $250,000.

Bank M's third method of adjusted trading involved the "sale" of $4 million of securities to an unregistered municipal securities dealer at prices more than three points above the market. This sale, executed through a separate broker acting as agent for the dealer, nominally occurred at the market, but Bank M then charged the dealer's account $124,000, which constituted the dealer's overpayment. In return, Bank M agreed to purchase about $8 million of municipal securities from the dealer at a price 1 1/2 points above the market, thereby reimbursing it for the $124,000 loss it had incurred. As a result of this transaction, Bank M avoided showing losses of over $100,000.

As a result of these adjusted trading practices, the published financials of Holding Company N understated its 1973 losses by about 19%. The trades also caused the overstatement of the value of Bank M's securities inventory by about $400,000.

Case # 7

O was a registered broker-dealer which had offices in two cities. O was a member of the NASD, and its primary business was trading in municipal and government securities.

O began trading GNMAs in 1978. In mid-1978, one of O's salesmen, without authorization, agreed to take a $4 million position in forward commitments to purchase GNMAs with a broker-dealer in New York. At that time, O had only nominal net capital. Interest rates moved up in the following two months and O sustained large losses which more than wiped out its capital.

O's difficulties in this period were compounded by problems it experienced in introducing a computerized recordkeeping system and by O's failure to maintain a manual backup system. These recordkeeping deficiencies were so serious that O was unable to compute its capital position at the time the large forward position was assumed.

It also appears that O engaged in unsuitable and fraudulent transactions in the account of one of its individual customers. This customer was a mechanic with limited formal education and a net worth of only a few thousand dollars. O promised to alert him whenever his losses exceeded $2,500. Nevertheless, one of O's salesmen used this customer's account to purchase millions of dollars worth of GNMA forwards, while assuring the customer that he would never have to take delivery on the certificates, and would only make money on changes in interest rates.

The SEC learned of O's net capital problems and its continuing operations while insolvent as a result of a routine NASD inspection. The SEC obtained injunctions against further violations against O, and its chairman and president. O was placed in receivership and administrative proceedings may also be instituted in connection with the same facts. None of O's customers sustained financial losses as a result of the firm's financial collapse, although other dealers lost more than $300,000 as a result of O's failure to honor its forward commitments. The favorable outcome for O's customers resulted in part from the prompt discovery of its poor financial condition by the NASD and the SEC and in part from O's observance of the reserve and segregation requirements under which customer funds were held in a separate bank account for their exclusive benefit.

<u>Case # 8</u>

P Government Securities, Inc. is an unregistered affiliate of Q, a large registered broker-dealer. P was organized in 1973 to deal exclusively in government securities and is, accordingly, exempt from registration with the SEC. Nevertheless, all of P's accounts outside of New York City are serviced by registered representatives of Q. P and Q have established specialized rules for determining which entity handles particular types of government securities transactions for their customers.

In late 1976, R, an account executive specializing in government securities employed by Q, opened and began servicing accounts at P for two medium-sized mid-western cities and a police and fire pension fund of one of the cities. The purpose of the new accounts was to engage in "arbitrage" transactions in United States Treasury securities. R's arbitrage strategy involved borrowing a Treasury Note through P and selling it on the market (the short position). Simultaneously, the proceeds from this sale were used to purchase another Treasury Note of the same denomination with a different maturity date and interest rate (the long position). The only funds that changed hands between P and the customer were wire transfers representing the differences in prices between the two notes.

The arbitrage position was established by selecting securities whose yield to maturity appeared to be out of line with their "normal" historical relationship. A security whose yield appeared to be low was sold short while a security with a current yield higher than its historical yield was purchased for the long position. R expected that the yield of the securities would return to their "normal" levels, and that the account could then profit by liquidating the arbitrage - i.e. selling the long position and buying in the short position. Securities with similar maturity dates were usually paired on opposite sides of the arbitrage, creating a partially hedged position. With this arrangement, market factors that caused one security to increase in value would also have an off-setting effect on the other security, resulting in little over-all effect on the account.

On R's recommendation, the cities and the pension fund engaged in arbitrage trading throughout the first half of 1977. None of them had engaged in arbitrage before, however, and they were not fully aware of the risks involved in an arbitrage strategy. The primary risk is that the yield of the securities involved may not move back to their historical relationship. In this event, the customer may recognize a loss on closing out the position. R apparently did not fully disclose this market risk to the cities. In addition, he failed to explain the borrowing charges assessed by P in connection with the arbitrage transactions.

At first, the transactions engaged by the cities and the fund were successful, and they recognized aggregate gains of nearly $170,000 in the first several months. Gradually, however, R began recommending transactions which resulted in larger and larger open positions and wider disparities between the maturity dates involved in the arbitrages. This strategy increased the possibility that a large loss could be realized if the market did not move as predicted. In addition, the transactions were not arbitrages in the same sense the earlier activities were because the partially hedged position which resulted from choosing securities with similar maturities was gone. R also failed to disclose the special risks inherent in this new strategy.

By mid-1977, the two small cities and the pension fund taken together had open positions of well over $300 million. 1/ Beginning about that time, the market for Treasury securities failed to move as predicted, and losses resulted in a number of the arbitrages. Since the three entities each had large arbitrage positions, even small market movements caused large paper losses. By June 30, 1977, the three had sustained paper losses of over $670,000.

The cities' fiscal years ended on June 30, 1977, and they wished to close their accounts to recognize any gains. To avoid having to close the accounts and report losses to the cities, R devised a scheme whereby Q wired funds to each of the cities and the cities wired back approximately equal amounts the next day. R also prepared and mailed ficticious confirmation slips from P showing closing and reopening of the cities' open positions in the arbitrages. The prices shown on the confirmations were not market prices, but prices that would show no gain or loss to the cities. In fact, no transactions had occurred and the accounts remained open. 2/ The actual losses were not discovered until August, 1977, during one of P's audits. By this time, further losses had occurred in the accounts.

As a result of R's arbitrage strategy, the accounts of the cities and the pension fund showed net losses of $1,300,000. Q assumed these losses. As a result of SEC enforcement proceedings against R and Q and judicial settlement of these proceedings, Q instituted new procedures to (1) prevent use of false confirmations, (2) require additional approvals for fund transfers to avoid occurences such as the June 30 sham transaction, (3) provide for disclosure of borrowing charges, (4) require approval of all arbitrage accounts, and (5) implement a periodic review procedure for P's accounts. R was barred from association with a broker or dealer for five years, and one of Q's supervisors agreed to undergo retraining.

Case #9

From 1976 until late 1977, the portfolio manager of a state university, who was charged with the responsibility of investing university funds in short-term highly liquid government securities, used the university's account to accrue financial benefits totaling approximately $1.3 million for himself and a group of friends and business associates through trading fees generated by transactions in government-guaranteed securities. Despite the university's conservative investment objectives, and without disclosure to the university, the portfolio manager engaged in a highly speculative, leveraged trading program. This program involved the trading of GNMAs on a forward basis as well as when-issued trading of sponsored agency securities. After becoming over-extended on these forward commitments the portfolio manager engaged in reverse repurchase agreements to fund delivery of the securities purchased. Through the use of reverse repos, the portfolio manager was able to "pyramid" the university's investments, i.e., borrow money against securities owned to purchase additional securities. This strategy resulted in university commitments exceeding $250 million at a time when its assets available for investment were only about $60 million. Published accounts have estimated losses to the university of about $17 million.

1/ Between January and September, 1977, R effected over 20 arbitrages for the accounts of each of the cities. He also earned $90,000 in commissions during this period.

2/ An investment manager for one of the cities knew it had a potential loss in its open positions and knew the June 30 "trades" were done away from the market. He approved the deal to give R time to remedy the situation.

While the portfolio manager often dealt directly with New York government securities dealers, he placed many of these transactions through broker-dealers owned by friends and associates, or that employed friends and associates. The portfolio manager himself was a part-owner of one such broker-dealer. One of those broker-dealers was registered with the SEC, while two others were not. In each instance the university was the sole, or at least the primary, customer of the broker-dealer or the salesman. These broker-dealers charged the university excessive mark-ups and commissions, and failed to disclose that they were also being compensated, at market rates, by the other party to the trade.

The university has not honored some of its outstanding commitments, resulting in suits for damages totalling approximately $1 million by two broker-dealers. One of the broker-dealers involved in the scheme is currently in receivership.

Case # 10

R was organized in 1977, was registered with the SEC as a broker-dealer, and was a member of the NASD. It operated a municipal and government securities business. S was a wholly-owned subsidiary of R's parent and was organized as an unregistered broker-dealer in 1978. S was incorporated separately of R, which had been losing money, apparently so that the government securities business could be conducted with less government regulation, including operating outside the net capital rule.

The trading practices used by the two firms in the sale of government-guaranteed securities, primarily GNMAs and FHLMCs, were similar and were carried out by R until S commenced doing business and continued the practices. The trading room was operated as a "boiler room," and telephone calls were made to potential customers -- frequently small financial institutions such as credit unions, banks, and savings and loans -- using sources such as bank directories and savings and loan directories. "Cold calls" to various types of potential customers resulted in a substantial number of sales. Salesmen for the firms were paid a commission of 40% of the firm's profits on each sale once the trades were settled. Sales were made without regard to the suitability of the purchase for the customer; salesmen made no inquiry of a customer's liabilities or net worth or other investment commitments. In a number of instances, customers of R and S entered into forward commitments for GNMAs and FHLMCs well in excess of the assets they had available to purchase the securities when the commitments became due. For example, a credit union with a net worth of $2.5 million was committed to take delivery of $5.5 million of government guaranteed securities within a month's time and had $11 million of additional commitments coming due in the following four months.

To enable some customers to avoid recognition of some losses they had incurred in their transactions, R and S entered into adjusted trades with these customers, purchasing the securities from them several points above the market, and selling other forward commitments to the customers at prices also several points above the market. Some salesmen testified that they thought such trades were permissible as long as the mark-ups did not exceed 5 points. To insure that the customers would honor these further commitments, the firms sometimes required "margin money" in amounts sufficient to cover R's losses on the adjusted trades. 3/

Existing customers of R were not informed when S was organized, even though many of their accounts were transferred to the new entity. Neither these customers nor new ones were told that S was not registered with the Commission, was not an NASD member, and was not insured by SIPC. The same salesmen continued to deal with the customers, the business was operated out of the same office, and, although separate books were kept reflecting the government and municipal business, the firms' salesmen were not even sure which entity paid them.

3/ One customer, a credit union, deposited over $60,000 of margin money in May 1978. A second payment of $446,156.77 was made in November 1978. Between $450,000 and $500,000 of this money was never returned to the credit union.

In part because of accounting requirements, S recognized substantial losses in its adjusted trading. Its accountant required it to "book" losses resulting from adjusted trading immediately, but would not allow it to recognize the gain from the forward commitment sold to the customer until settlement. As a result, by the end of 1978 it had a negative net worth of over $600,000. Despite this insolvency, it continued doing business.

Through much of 1978, R and S borrowed money from a southern city through a series of repurchase agreements covering government guaranteed securities. In late 1978, S, while insolvent, began using funds borrowed from the city in its operations without maintaining the securities as collateral. In a practice termed "bucketing," it sent false confirmations to the city purporting to show purchases of the collateralizing securities when in fact no such purchases were made. In late 1978 and early 1979, the amount of uncollateralized funds was approximately $1.4 million. During this period, the management of the firm changed, and the $1.4 million was thereafter returned to the city. Included in this money, however, was approximately $500,000 of margin money of a credit union.

The changed management also refused to allow any more adjusted trading, and attempted to remove all the losses it had accumulated on its balance sheet through the adjusted trading by instituting a system of "swaps", which effectively closed out certain open positions for customers. The customers agreed to such "swaps" because R's management had represented that the losses which had been encountered and were hidden through the adjusted trading would not have to be recognized by the customers. In fact, the losses were recognized at this time.

One customer recognized a loss of $1.4 million and also lost about $500,000 in margin money which was not returned. Two other credit unions recognized losses of over $20,000 each.

A permanent injunction was entered against S in early 1979. Three of that firm's salesmen and its manager have been barred from the industry. Administrative proceedings are pending against R and certain other persons.

<u>Case #11</u>

Company U is a no-load, open-end management investment company registered with the SEC under the Investment Company Act of 1940. U's investment objective is to provide current income to shareholders primarily through purchasing securities which are obligations of or guaranteed by the U.S. Government. In 1977 and 1978, the majority of U's portfolio consisted of GNMA certificates and other government guaranteed loans.

Broker T has been a registered broker-dealer and investment advisor since 1973. T shares offices with U and advises U on its investments. In addition, T and U have had at least two common officer-directors, including a common president, and these two individuals were primarily responsible for the selection, purchase, and sale of U's portfolio investments, including GNMAs.

A Commission inspection of U under the Investment Company Act revealed that commencing in 1977, U traded GNMA forwards and standbys and entered into reverse repos. By December 31, 1977, U had over $42 million in GNMA commitment in its portfolio, while its total assets other than these commitments were only $46 million. In its prospectus and advertisements to its existing and potential investors, U extolled the safety of its investments, stressing that the U.S. Government guaranteed them all. It did not apprise these investors of the risks inherent in forward contracts, standbys, and reverse repos; namely, the speculation in interest rates and the possibility of having to purchase GNMAs at a loss or when the company might not have sufficient funds to cover the purchase. In addition, U's financial statements understated the amounts of GNMA commitments held.

U's massive GNMA commitments came to the attention of U's board of directors in early 1978. (Under the Investment Company Act, 40% of U's directors were required to be independent of the company and its advisor.) The Board instructed the common officers of T and U to cease issuing commitments for GNMA forwards, and the Board further required those officers to execute an

indemnification agreement to U for losses it may have on $20 million in commitments as a quid pro quo for continuance of T's advisory contract with U. Pursuant to the indemnification agreement, the common officers reimbursed U for $700,000 in commitments losses. An additional $90,000 loss remains unreimbursed. Subsequent SEC proceedings resulted in additional monetary and non-monetary relief.

Case #12

W, an independent unregistered broker-dealer, was organized in late 1977. During 1979 it raised at least $6.5 million from investors by purporting to enter into "repurchase agreements" on guaranteed student loans ("GSL's"). Apparently, however, W did not have GSL's as collateral, and it defaulted upon $4,500,000 in payments on these "repurchase agreements," and issued over $1,000,000 worth of dishonored checks in connection with two of these agreements.

W engaged in these transactions with credit unions, S & L's, banks, insurance companies, and other institutional investors. It represented that the GSL's were to be held by third parties or by the broker-dealer for the purchaser. However, the broker-dealer, after receiving funds from the customer, failed to produce the securities, even when requested. At this time it is unknown whether any securities were ever produced for any customer.

W told investors to whom it purportedly sold GSL's, among other things, that these securities were safe investments and were guaranteed by the Office of Education of HEW. W also told investors that it was in sound financial condition and would be able to repurchase the securities.

State authorities as well as the SEC have taken action against the broker-dealer and its principals. A receiver was appointed in the SEC action, and the company is presently in bankruptcy proceedings. Several private lawsuits are also pending. Because no meaningful records have yet been located, it is unclear how many institutions or other investors suffered losses. The total amount of the losses is also unclear, although it apparently exceeds $4,500,000.

Case #13

X, an unregistered government securities dealer, was affiliated with a registered municipal securities broker-dealer. The two firms were controlled by one individual and shared offices, management, and sales staff, but maintained separate books and records. X is presently insolvent and has filed a petition for bankruptcy. As a result of X's past trading activities, small banks, credit unions, and over 40 individuals may ultimately suffer losses exceeding $8 million.

X's financial collapse and the resulting losses to its customers appear to have been the result of a Ponzi-like scheme furthered by misrepresentations and omissions of material facts concerning both the nature of the investment packages it was offering to the public and the firm's financial condition. Beginning in early 1978, X engaged in selling GNMA securities to customers on a stand-by basis. Stand-bys are essentially put options -- the dealer pays the customer a fee for agreeing to "stand by" to purchase a specified amount of securities at a certain yield if the dealer exercises his option to sell the securities. By mid-1977, X had paid stand-by fees totalling $7 million. In order to pay these fees, X obtained funds from other customers through the use of "stand-by with pair-off" transactions. Pursuant to these transactions, X would purport to sell GNMA securities to the customer for forward delivery and, at the same time, would execute a stand-by commitment to repurchase the securities at a higher price on the settlement date. X would require payment of a stand-by commitment fee from the customer on the trade date. Customers were promised a return of 11-13% on their investments. This return consisted of the difference between (a) the price at which the customer would resell the securities to X, and (b) the amount paid by the customer for the securities plus the firm's stand-by commitment fee.

X, however, did not tell investors they were entering into "standby with pair-off" transactions; rather it told investors that their funds were being invested in existing GNMA securities, and that these investments were fully collateralized, were segregated from other customers' funds, and were guaranteed by the federal government. X further stated that these securities

were being held in safekeeping by a bank and that the securities could be sold at any time prior to settlement date. In fact, however, X did not purchase any GNMA securities for customers with whom it entered into "stand-by with pair-off" transactions, and no such securities were held in banks on behalf of the investors. These transactions were merely unsecured loans to X. X used the funds to pay stand-by commitment fees it owed to customers; pay fees to other customers to induce them to enter into stand-by commitments at above-market prices; repay with interest the funds owed to other "stand-by with pair-off" customers whose settlement dates had arrived; pay "finder's fees" to persons who referred customers to X; pay "management fees" to its registered affiliate; and pay its expenses, including the extremely high commissions it paid its salesmen. In addition, a substantial part of this money was retained as "profit," and X apparently also used some of these funds to invest for its own account.

In addition to the misrepresentations and omissions concerning the nature of the investment packages it was offering, X misled its customers with false statements concerning its financial situation and its status as a broker-dealer. In response to requests for information concerning its financial condition, X provided customers with a combined financial statement for it and its registered municipal securities affiliate, which was in far better financial condition than X. This statement served to conceal X's precarious financial situation. Moreover, the cover page of the financial statement contained the legend "Member Securities Investor Protection Corporation - National Association of Securities Dealers, Inc." X, however, was not a member of either SIPC or the NASD.

By mid-1979, X's financial condition had become desperate. In July - August the firm had a negative net worth of between $150,000 and $300,000. It continued to conduct business in this condition for several months, with the exception of a one-month period when the firm ceased operating because it did not meet the minimum net worth requirements of the state under whose laws it was organized. State and federal enforcement actions, and a declaration of bankruptcy, followed in late 1979. According to the most recently available financial information, X presently has about 165 open trades with about 75 different customers. These customers include credit unions, banks, savings and loan associations, trust accounts, and individuals. The firm's contractual obligations through February 1981 include repaying its "stand-by with pair-off" customers about $11.4 million in principal and about $1.4 million in accrued interest. At this point, it is unclear what the ultimate losses occasioned by X's activities will be, but based on information X has filed with the bankruptcy court, they will evidently exceed $8 million.

X contends that the stand-by with pair-off contracts were legitimate hedge transactions, and that its financial difficulties were caused by defaults on GNMA forward commitments by a New York broker-dealer and a large investor. X apparently had purchase and sale agreements with the broker-dealer covering delivery of $321 million in GNMA securities in 1979 and 1980. X charges that the New York firm unjustifiably repudiated these agreements in September, 1979. These claims are currently the subject of private litigation.

It appears that two principals and several salesmen of X may currently be continuing X's activities at a newly formed, unregistered broker-dealer establishment.

Case #14

Y was an unregistered government securities dealer, affiliated with a registered municipal securities broker-dealer. From mid-1977 to mid-1979, Y sold hundreds of millions of dollars of delayed delivery contracts in government securities, principally GNMAs, to a variety of customers, including small banks, S & L's, trust companies, and a substantial number of individuals. Many of these contracts called for settlement beyond six months in the future. The unregistered dealer generally attempted to cover its future delivery obligations by purchasing delayed delivery contracts from primary government securities dealers in amounts and yields sufficient to protect it from risk due to market fluctuations.

Problems arose with this hedging strategy, however, because contracts for settlement longer than 6 months in the future are generally not available from issuers or other government securities dealers. Accordingly, Y employed a strategy known as a "rolling hedge". In practice this meant that when it

sold a delayed delivery contract of greater than 6 months duration, Y would purchase a contract in the same principal amount and yield but with a settlement date of 6 months or less. When the settlement date on this purchase arrived, Y would pay for the contract, immediately sell it, and use the proceeds (plus or minus an additional capital contribution, depending on the market) to purchase a second contract of a duration, yield, and principal amount chosen to cover its outstanding obligation. However, even when final settlement dates on purchases and sales were perfectly matched, maintaining the rolling hedge required very large temporary investments of capital in a declining market and, because of its thin capitalization in relation to its outstanding obligations, Y found itself with severe cash flow problems. For example, the rolling hedge itself consumed additional funds of nearly $7,000,000 during one four month period in late 1978. This would have forced Y to cease doing business if it had not employed several questionable or fraudulent business practices described below.

Y's cash flow problems were exacerbated by "coupon conversion losses" it experienced as a result of its business strategy. Y frequently engaged in repo transactions -- using GNMA collateral to raise short term working capital. In many instances it repurchased a similar, but not identical, security at the repo termination date. In several instances, a coupon rate change occurred in the GNMA market between the time of sale and repurchase, making it difficult for Y to obtain securities with the same coupon as the original collateral. A similar problem occurred with the rolling hedge strategy described above, since there were coupon rate changes between the time Y sold standbys or forward commitments and the time it rolled over the standbys or forwards it had purchased to hedge its sales. For tax and other reasons, some customers refused delivery of GNMA's with coupon rates different than those they had contracted for, even though they offered the same yields. This forced Y to pay premiums for GNMA's satisfactory to its customers since they were no longer readily available in the market place. During 1979, these "coupon conversion" losses totalled nearly $3,000,000.

The traders at most of Y's small institutional customers were unsophisticated with respect to the government securities market. At least two of Y's customers cancelled several trades for delayed delivery and standby contracts during the declining market of early 1979 -- one of the institutions claiming that salesmen failed to disclose the risk factors associated with trading in GNMA forward commitments and standbys. Also, Y sold forward commitments of over $12,000,000 to one trust company which thereafter cancelled the contract and subsequently went bankrupt. Y absorbed a loss of almost $500,000 in connection with these transactions.

In late 1978, when Y's cash position became critical, it began selling standbys without purchasing similar standbys to hedge its position. In doing this it gained working capital since it realized the entire standby fee without having to pay a substantial portion of that fee to hedge its position. In effect, however, the dealer was betting that the GNMA market would rise so that its customers would not exercise their standbys, and it was exposing itself to a risk of substantial loss in the event the market continued to decline. In fact, the latter situation occurred, and Y lost in excess of $2 million in these transactions.

By early 1979, Y's financial situation deteriorated to the point where it engaged in outright fraudulent repo transactions to obtain the necessary capital to stay in business. On several occasions it approached two of its customers, a privately held trust and a publicly owned insurance company, and convinced them to "purchase" GNMA securities in repo transactions from unidentified "customers" of Y. The two purchasing customers paid a total of $4,200,000 in margins in the alleged repo of $137,000,000 of GNMA's during the first half of 1979. They were induced to enter this transaction by the offer of a very attractive 26-28% annual return on their investment. In fact, however, there were no selling "customers" and no underlying GNMA. In effect, the trust and the insurance company unwittingly made unsecured loans to Y, which was able to cover the deception for several months by paying the "purchasers" the profit due from the "repos" and inducing them to take part in larger and larger transactions. The true situation, however, could not long be hidden because Y's financial condition deteriorated to such a point that it could no longer maintain this facade.

In late May, 1979, Y approached the trust and the insurance company and revealed its fraudulent activity. It convinced these customers that it would be unable to continue in business without additional working capital and that the only way they could recoup their losses was to infuse an additional $3,100,000

to be repaid when Y's extensive hedge position began unwinding in late 1979. The customers acquiesced but demanded and received the right to review Y's finances and oversee its future operations. In late summer, 1979, Y was unable to repay the loans. The customers converted their debt positions to equity and replaced Y's officers and directors. Y's apparent net worth, as of August 31, 1979, was negative in the amount of about $6,500,000.

Case # 15

A now-defunct registered broker-dealer, W, with offices located in several southern cities, was primarily engaged in the business of buying and selling GNMAs but also engaged in an occasional municipal bond transaction.

In September, 1979, the SEC determined, based upon information received from the NASD and a subsequent examination of the broker-dealer's books and records, that the broker-dealer was in violation of the net capital and bookkeeping requirements of the federal securities laws. It appeared that the broker-dealer owed its customers approximately $1 million for their credit balances and did not have funds available to pay them. The broker-dealer had apparently been operating with a net capital deficiency for at least several weeks and had effected about 80 customer transactions during that period. Although the cause of the financial collapse is unclear, it appears that a major part of the problem was that interest rates rose rapidly causing the value of its government securities inventory to plummet.

W engaged in forward transactions in GNMA for its own account, and sold GNMAs to customers, including many retired persons, on a cash basis. W's salesmen, who were paid commissions as high as 45%, appear to have made misrepresentations to some customers regarding, among other things, the risks associated with GNMA transactions and the fact that the monthly pass-throughs represent a return of principal as well as interest, and therefore decline over time. There also appear to have been problems concerning timely payment of principal and interest.

A SIPC trustee has been appointed and liquidation is proceeding. SIPC has already paid approximately $3 million in connection with this case, but it may recover a portion of this expenditure from W's assets.

Case # 16

AA is a registered broker-dealer that during the period discussed herein engaged almost exclusively in municipal securities. In 1971, a small national bank with deposits of $70 million and equity of between $4 and 4 1/2 million, opened an account with AA. During 1974 and 1975, adjusted trades were made between AA and the bank. Adjusted trades are transactions at prices above the market which are designed to cover up or defer losses on portfolio securities. To hide such losses in its investment portfolio, GNMA certificates and municipal securities owned by the bank were sold to AA at prices adjusted as much as 30% above the market, and in related transactions the bank purchased new investment securities from AA also at prices above the market. During 1975, trades with the bank resulted in profits to AA of over $600,000. The bank ceased doing business with AA in 1975 at the insistence of the Comptroller of the Currency.

Losses to the bank on the transactions from 1973 through 1977 total at least $700,000 and there is an additional $1 million in unrealized losses on securities not yet liquidated as of mid-1979.

In mid-1979, the SEC, through settlement with the principals, censured AA for its activities with the bank and imposed administrative sanctions against 4 of AA's principals.

Case # 17

BB is an unregistered broker-dealer engaged in transactions in U.S. government issued and guaranteed securities. It is affiliated, and shares offices and personnel, with a registered broker-dealer.

In late 1978, BB defaulted on its reverse repo agreement to deliver a $1 million GNMA certificate to a savings & loan company ("S & L"). The S & L inquired about the status of this GNMA and about a separate $1 million government guaranteed State of Israel bond held by BB on another reverse repo and found that BB had hypothecated both securities to other lenders and was unable to redeem them. On the same day, BB defaulted on a loan secured by a government security held by a registered broker-dealer. This broker-dealer then recalculated its secured position as lender to BB in many repos and reverse repos and a few days later demanded additional security under the terms of its agreements. BB could not meet this demand and, three days later, BB filed for reorganization under the Bankruptcy Act.

An inspection of BB and its affiliate indicated major irregularities and apparent customer losses in BB's operations, but few if any major irregularities and no customer losses in the operations of its registered broker-dealer affiliate. BB utilized a simplistic and often unreliable recordkeeping system. BB also distributed false, unaudited financial statements which did not reveal its precarious financial condition. In contrast, BB's registered affiliate took great efforts to ensure that its books and records provided an accurate basis for NASD FOCUS reports, and thus achieved a far more accurate and complete recordkeeping system than that of BB.

In one category of irregularities, BB had failed to pass through monthly payments on GNMA securities held by BB for safekeeping or on repo or reverse repo agreements. Seven financial institutions and three broker-dealers were thus deprived of three months of pass-through payments on these securities, or about $240,000. In a second major category, BB hypothecated many securities that were held by it but were owned by or committed to customers or other dealers. In twenty-five reverse repos, BB had lent about $11,000,000 and had then pledged or repoed the same certificates as security on loans to itself from ultimate lenders in an aggregate amount of about $16,000,000. (BB had also pledged some customer securities that it was simply holding for safekeeping.) The difference of nearly $5 million was deposited in BB's general operating account and exhausted on operating or other expenses. BB's customers were not advised of this use of their securities nor the possibility that BB would be unable to redeem the securities or return them to the customers.

BB was declared bankrupt in mid-1979. Schedules compiled by the trustee in bankruptcy in early 1980, indicate losses of approximately $15 million to financial institutions and other broker-dealers who dealt with BB. Some creditors were allowed to liquidate the assets they held for BB against their claims. As a result, they were included as defendants in suits filed by 11 of BB's numerous remaining creditors.

BB's creditors include banks, credit unions, pension funds, savings and loan associations, generally with assets of less than $30 million, and individuals. Their claims further illustrate the practices BB engaged in. For example, one New York S & L filed a civil action alleging that, beginning in early 1977, BB borrowed about $3.5 million from it, pledging as collateral five GNMA certificates and that BB either repledged the GNMAs or disposed of them in violation of the agreement. These certificates were never delivered to the S & L. Likewise, an S & L in Texas claims that BB or its agent wrongfully sold a $300,000 GNMA certificate that was delivered as collateral and not in a sale. Finally, a registered broker-dealer claims BB defaulted on its purchase of GNMAs for forward delivery.

BB's affiliate, a registered broker-dealer, also went bankrupt, chiefly due to guarantees given on BB's transactions and not due to any sales improprieties of its own.

<u>Case # 18</u>

CC, an unregistered broker-dealer firm, has been engaged in the purchase and sale of U.S. government-guaranteed securities since its its inception in February, 1976. CC is an affiliate of a registered municipal securities broker-dealer. CC and its registered affiliate shared the same 12 salesmen but kept separate books and records.

In early 1977 the SEC received information from the Comptroller of the Currency and other sources indicating that the unregistered broker-dealer may have committed violations of the federal securities laws in connection

with the sale of GNMA securities to a national bank. The information indicated possible violations which included unauthorized trading, a failure to disclose adequately the potential risks in certain GNMA transactions, and excessive mark-ups and mark-downs. There was no indication of any irregularities by the registered affiliate. CC has vigorously opposed enforcement of subpoenas issued in the SEC's investigation, and it is currently appealing a subpoena enforcement order of a federal district court.

Case #19

A mortgage banker and its predecessor firms have been FHA and VA approved lenders since 1971. The mortgage banker originated GNMA modified pass through certificates from early 1975 until mid - 1979, and it had more than 20 offices nationwide. The current president, chief executive officer and principal shareholder of the mortgage banker is an individual who has been in control of the firm since 1974 and is responsible for placing in the secondary market the mortgages originated by the firm.

During the period from early 1975 until mid-1979, the mortgage banker originated VA and FHA loans primarily on single family residences, pooled these loans, applied to GNMA for certification, and, after receiving GNMA certification, sold these loans. The mortgage banker would continue to service the loans which it had sold, receiving servicing income of .44 percent of the total amount of mortgages serviced. In 1978, the mortgage banker's servicing income was nearly $2,000,000 and its total GNMA servicing pool was nearly $600,000,000.

By 1978, the mortgage banker was originating and closing approximately $30 million a month in home loans. Lacking the capital to operate at this volume, it utilized "warehousing" credit arangements with approximately twelve banks throughout the United States. The warehouse banks required the mortgage banker to provide them with written commitments evidencing that it had received commitments for future delivery of the GNMA certificates. In this way, the bankers were protected from adverse interest rate changes.

The process of selling forward commitments in GNMAs or selling "short" is commonly used by mortgage bankers to "lock in" an interest rate. The mortgage banker normally sold "short" its future production and went "long", or purchased forward commitments, only to pair off certain short positions to take advantage of upswings in the market. Beginning in early 1979, however, the mortgage banker began to speculate in the GNMA forward market. Over a period of approximately 3 months, the mortgage banker entered into forward commitments with 12 securities dealers. The size of the positions taken by the mortgage banker were greatly in excess of the normal hedging activity and the "net" position the mortgage banker held was a long position obligating it to take delivery rather than a short hedging position.

During a two month period in early 1979, the mortgage banker's net position ranged from $180 million to over $350 million long. With $75 million in GNMA settlements coming due in mid-April, the mortgage banker called a meeting with the customer-dealers and told them it could not honor its commitments. The customer-dealers, although attempting to minimize their losses, incurred losses of approximately $5.2 million. Of this amount, approximately $3 million was repaid pursuant to the terms of a settlement between 11 of the customer-dealers and the mortgage banker.

In addition, during this period, the mortgage banker was receiving the proceeds from the sale of GNMA's and failing to remit them promptly to its warehousing banks. When the banks learned of this failure to honor its commitments and foreclosed on the loans pledged as collateral, they discovered they were approximately $8.6 million short. The mortgage banker subsequently agreed to pay the banks this entire amount pursuant to the terms of a settlement agreement. 6/

6/ The large losses suffered by the banks were partially a result of misrepresentations that loans would be paid promptly upon receipt of payment of a GNMA certificate, and partially due to lack of diligence on the part of the banks in ensuring that they were properly collateralized and that the mortgage banker promptly paid them. In addition, new GNMA regulations, effective April, 1979, required banks to release any security interest on loans for GNMA pools at the time the certificates are issued.

The mortgage banker was able to obtain such a large net long position in the market for three reasons. First, although it was "long" with 12 separate dealers, it falsely represented to each dealer that it was long only with that dealer, and was net short because it had short positions with other dealers. It also represented it was buying from only one or two other dealers. Second, the mortgage banker and its CEO were viewed by all the dealers as sophisticated investors, both because the mortgage banker had a servicing portfolio of nearly $600 million in GNMA mortgages, and because the CEO had apparently made money in speculating in GNMA's in the past. Third, the absence of a mark-to-market or margin maintenance requirement allowed the mortgage banker to acquire a large position without posting any funds or having any limit imposed on it. As a result of these three factors, a number of firms sold large amounts of forward commitments to the mortgage banker that would otherwise appear unsuitable, resulting in the latter's having, on the date of its defaults, forward commitments to buy GNMAs from customer-dealers totaling $75 million. When these commitments started coming due for settlement, the mortgage banker was unable to "pair them off", did not have sufficient funds for settlement, and defaulted.

Prior to the actual default by the mortgage banker, it had attempted unsuccessfully to enter into reverse repurchase agreements with a number of the dealers in order to roll over the contracts due for settlement. After the default, the proceeds from the sale of the mortgage banker's servicing contracts netted about $7.1 million and the mortgage banker was therefore able to pay its banks 100% of their losses, and its dealers, 65%.

In May, 1979, GNMA revoked the mortgage banker's issuer/servicer status. Nevertheless, the mortgage banker continues to originate FHA and VA loans and is selling them to one customer that is creating GNMA pools.

Case # 20

DD has been a registered broker-dealer since 1975 and is primarily engaged in the sale of government and municipal securities. It has nineteen salesmen and 190 active customers. A substantial portion of DD's business has consisted of the offer and sale of forward commitments to purchase GNMA securities. DD stopped selling GNMA forwards in February, 1979, because of a declining market and net capital problems, but has resumed as of January, 1980.

In early 1979, three savings and loan associations and a bank that had traded with DD charged that one of its salesmen had executed unauthorized trades of GNMA forwards for their accounts. At that time the four customers' accounts already showed unrealized losses of approximately $400,000 on GNMA forward transactions involving commitments of $13 million. Although it received written notice of the customers' intention not to honor these GNMA contracts, DD failed to deduct the unrealized losses from net capital as required by rules promulgated under the Securities Exchange Act. DD also failed to take the other required deductions in computing its net capital.

DD's net capital deficiencies were discovered shortly after the customers' notices as a result of a complaint one of the customers filed with the SEC, and an SEC inspection conducted immediately thereafter. When informed of deficiencies amounting to $703,735, DD immediately ceased conducting business. It then entered into an agreement with a primary dealer whereby the dealer assumed the obligation for the $13 million in GNMA forwards in consideration of future underwriting revenues. This assignment remedied the net capital deficiencies and DD resumed business shortly thereafter. None of the four customers lost money on the apparently unauthorized transactions, since DD assumed the losses. The salesman is no longer employed by DD.

It should be noted that the four customers had been trading GNMA forwards for two or three years and apparently understood the market. They had also made repeated transactions with the salesman accused of the unauthorized trading. In disclaiming the subject transactions, the customers pointed to the fact that they did not sign the authorization forms usually sent out by DD on such trades. The salesman, however, claims that these transactions were orally authorized by the banks and that the banks repudiated the trades because of the drop in the market at the time. It is also noteworthy, however, that DD had been having net capital problems for some time and that it was only pursuant to a previous settlement agreement with the SEC that DD subjected its government securities transactions to the requirements imposed on its registered broker-dealer activities.

Case #21

A registered broker-dealer and certain of its unregistered affiliate dealers transacted business in GNMA forwards and other government issued and guaranteed securities for forward delivery primarily with small and medium sized credit unions and savings and loan associations. The dealers' salesmen were, for the most part, inadequately trained and lacked experience in the securities field. These salesmen generally did not inquire as to the financial condition or investment objectives of these instutuctions. They represented that profits were virtually certain to be earned with no margin deposit or cash payment, or the necessity of taking delivery. They often neglected to mention, or misrepresented, the market and credit risks inherent in the securities offered. Portfolio managers invested heavily in these securities, often well beyond their financial ability to fund or beyond in-house trading limits of the dealer. For example, one small federal credit union, at one point, had an amount of commitments in these securities equal to 3/4 of its total assets.

When interest rates began to rise, these institutions, fearing large losses and the inability to fund securities at settlement, turned for relief to various techniques suggested to them by the dealers' salesmen. One technique used by over a dozen customers was adjusted fee trading. Under this approach, one of the dealers would buy back a security sold for forward delivery at the original contract price, i.e., a price above the then current market, and simultaneously sold (sometimes from a short position) the customer another security for forward delivery at a price over the market by an amount equal to the loss involved in the original contract. The customer was also required to pay an additional charge which the dealer used to cushion its loss on the original contact. Several salesmen advised their customers to post the loss mark-up and charge on their books as an asset, thus deferring the loss at least until the settlement date for the second commitment. By then, salesmen told their customers, prices would rebound enough to cover these amounts. Unfortunately, prices continued to decline and some institutions lost thousands of dollars in charges when securities were liquidated at prices lower than their original cost. Confirmations sent by the dealer to its customers seem to have masked the economic substance of the transaction by indicating that the settlement had simply been extended at the original contract price.

Investors also started transacting reverse repos with the dealers when they found themselves with a market loss or with insufficient funds to pay for securities at the delivery date. The investor would receive the coupon interest on the security sold to the dealer and pay a financing fee to the dealer. As interest rates rose and repos were rolled over, market value of the securities continued to decline and the fee often exceeded the coupon rate. As a result, several savings and loan associations found themselves with large losses and sometimes in violation of FHLBB borrowing limitations. The dealers also seem to have sold these securities at a price higher than the prevailing market in a number of cases.

Although it is difficult to quantify losses at this time, a substantial number of institutions have realized or unrealized losses in excess of $50,000, a few with losses of at least $250,000.

Case #22

An unregistered affiliate of a registered broker-dealer seems to have engaged in adjusted trading with certain of its customers. These customers, savings and loan associations and credit unions, had purchased GNMAs and Federal Home Loan Mortgage Corporation Participation Certificates (PCs) for forward delivery and had significant losses resulting from a decline in the market price. Some of these customers were induced to purchase these forwards because of the payment of "up-front" money by the dealer. In this case, the affiliate, often at the customer's request, would pay one point (1% of the principal amount of the transaction) to its customer shortly after the trade date and raise the price of the security by one point over the current market price. The customer then booked as income some or all of the "up-front" fee, even though the customer sometimes liquidated its obligation at a loss before settlement date. The recognition of "up front" payments apparently materially increased customer income.

The affiliate was also involved in questionable or improper activity in connection with sales of forward commitments where no money initially changed hands. In some instances, customers incurred unrealized losses because of a decline in market price and the affiliate, at or about the settlement date, confirmed the buy-back of the securities at the original higher price which the customer had agreed to pay. Simultaneously, the affiliate either "sold short" or "long" to the the same customer forwards or securities with the same principal amount and coupon, which it purchased in the market, at the lower market price, with a future settlement date. The affiliate confirmed sale of such securities at the higher original transaction price to the customer for later settlement. This type of transaction required the customer to pay a mark-to-market fee to the affiliate, which was disguised as an advance payment on the new contract, instead of being shown as a loss. Often the customers were unaware of these "adjustments"; rather, they believed that they were just extending their settlement dates.

In addition, one customer of the affiliate apparently sustained additional losses when it over-extended itself by entering into reverse repos with the affiliate's unregistered parent.

Millions in realized and unrealized losses were incurred by the customers of the affiliate and its parent.

Case # 23

Three complaints have recently been filed concerning an unregistered government securities affiliate of a registered broker-dealer. A federal agency, which had responsibility for administering certain trust funds, was a customer of the unregistered affiliate. The agency purchased, in November of 1978, approximately $760,000 worth of FMHA loans from that firm but never received the supporting documentation. In February, 1979, a bank in Mississippi and a federal credit union in Pennsylvania purchased approximately $150,000 and $200,000, respectively, of these same securities and likewise never received any supporting documentation.

Upon initial inquiry, it seems that the unregistered affiliate purchased the loans for its own account from an issuing bank in Florida and resold them to the complaining customers. The customers wired their money to the firm's account at a New York bank, but the issuing bank filed for bankruptcy during this period and did not deliver the notes to the unregistered affiliate. To escape liability on the sales contracts with its customers, the unregistered affiliate is now claiming that it acted as agent for the customers and not as principal.

While the facts of the case are not clear, it appears that the unregistered affiliate may have been over-extended in GNMA commitments and was therefore unable to meet its commitments when the issuing bank defaulted. It is also worth noting that the acknowledgments and confirmations sent by the unregistered affiliate gave no indication of whether the dealer was acting as principal or agent in the purchases although confirmations for transactions in non-exempt securities are required to contain this information. Confirmation rules applicable to non-exempt securities require the dealer to state his status in the transaction.

The total amount of funds involved in the three complaints is $1,100,000. At this time it is not known whether other customers were affected or what the ultimate losses will be. On December 21, 1979, the unregistered affiliate filed for bankruptcy.

Case # 24

NN is a small regional broker-dealer, a NASD member, and not a member of any exchange, although it clears through a member firm. Since 1975, NN has specialized in publicly traded municipal and other government bonds.

From January 1976 until October 1976, NN acquired approximately $2 million of Tennessee Valley Authority ("TVA") Bonds and sold them to more than 300 customers. NN actively marketed these bonds by means of newspaper and radio advertisements. Most sales transactions were conducted by the phone. Neither NN, nor its registered principals, ever informed their

customers that these TVA bonds were callable. 5/ Shortly thereafter, customers lost approximately $73,400 when TVA exercised its redemption clause. Thus customers lost the difference between the premium price they paid and the lower redemption price.

Seventy-five percent of NN's new business was generated by its advertising program. NN ran about four or five newspaper advertisements per week. During the summer of 1976, NN advertised certain energy related revenue bonds as being "guaranteed by a U. S. Government Agency," when no such government guarantee existed. Finally, NN ran advertisements giving false yields on Government Services Administration Bonds. Apparently, no losses to customers resulted from these activities.

In early 1977, the NASD filed a complaint against NN and its two registered principals. They were found guilty of fair practice violations regarding NN's advertising activities. All respondents were censured, one principal was suspended for three years, and the other principal was barred from being a registered principal and fined $5,000. A subsequent SEC administrative proceeding was based on NN's lack of disclosure of pertinent information on the TVA bonds and inaccurate advertising on the GSA bonds. The SEC suspended the firm and its principals for various periods of time, required new supervisory procedures, especially regarding advertisements, and required the firm and the principals to disgorge to the bond purchasers profits made on these transactions.

Case # 25

Two employees of a regional office of a major registered broker-dealer apparently engaged in unsuitable trades, churning, misrepresentation and a fraudulent course of conduct in GNMA transactions. The investors involved were generally unsophisticated and included an elderly retired school teacher who was allegedly strongly encouraged by the registered representative into opening a margin account and making purchases in, among others, GNMAs. Apparently as a result of active trading in her account, the value of her portfolio declined from over $200,000 to about $28,000 in one year's time.

In addition, the second employee, a vice-president at the same regional office, apparently encouraged a second investor to buy a $1 million GNMA after falsely saying that he had already purchased it for the investor's account. The salesman seems to have made made certain misrepresentations to the investor and failed to state other material matters, including the cost of the security, his interest costs and the commission charge of $16,534. This investor is claiming a loss of $120,000 since April, 1978, and has filed an action against the registered representative and the broker-dealer.

A third investor, a retired contractor, was seeking a risk-free investment with a 9% or better return. The registered representative reportedly told the investor that a purchase of certain GNMAs could yield a 19% return, made misrepresentations as to the costs the investor would incur on his margin account, and gave the investor unauthorized and misleading sales literature. Subsequently, the investor, contrary to the registered representative's advice, sold at a loss of approximately $60,000.

A fourth investor, an elderly businessman who had just sold his business upon retirement, invested $9,911,000 in GNMAs for his and his wife's trust accounts. The registered representative told him that such a purchase could yield a 19-21% return and was risk free. This investor lost over $2.6 million in 15 months. Total losses aggregate $3 million.

Case # 26

MM is a family-controlled corporation approved as a trust company in 1964. As a trust company, it is supervised by a state banking commission. Its primary business is the investment of funds deposited by the public. MM also functions as a trust company for individuals and businesses. The company is now insolvent, having filed a voluntary petition for bankruptcy in December, 1978.

5/ Bonds are callable when the issuer reserves the right to redeem the bonds prior to maturity. Such a provision may require the issuer to pay some amount over par, the amount over par being referred to as premium. In this case, TVA paid 106.3 on redemption. During the period of the sales campaign, NN was selling these bonds at a premium greater than 106.3.

MM solicited deposits from the public and issued certificates of deposit and passbook accounts. In its sales literature, MM acknowledged that its deposits were not insured by the Federal Deposit Insurance Corporation but represented that its depositors had comparable security because it had a fidelity bond which protected against losses from embezzlement, and because it engaged only in the safest possible investments. MM received $7 million in deposits from 850 investors, most of whom have incomes in the $20,000 - $30,000 range. In addition, a large number of investors were retired individuals who were attracted by the advertised safety of MM's investments.

Contrary to its representations, however, MM used these funds for speculative investments in GNMA forward commitments and other securities. In addition, some of this money was apparently diverted to the accounts of insiders. Its total assets now amount to $5.2 million, but a significant portion of this amount is pledged for financial transactions. In addition to the money it owes investors, MM has outstanding commitments totalling $14 million in connection with GNMA forward transactions.

Although the state banking commissioner, in May 1977, prohibited all state trust companies from trading GNMA forwards, MM continued to participate in this market. 6/ In late 1978, MM had open transactions involving $7 million worth of GNMA forwards and $7 million of Treasury securities with a registered New York broker-dealer. MM, however, could not afford to pay for these securities and on settlement date, entered into reverse repurchase agreements with the broker-dealer. After the banking commissioner discovered $1.4 million in losses in connection with these transactions, MM directed another government securities dealer to sell the $7 million in GNMA's, but did not inform the dealer that these securities were collateral being held by the New York broker-dealer in connection with the repurchase agreements. The $7 million in Treasury notes were apparently sold by another dealer. MM attempted to conceal these losses by manipulating the entries on its uncertified financial statements. In November and December 1978, in an apparent attempt to recoup its losses, MM purchased about $14 million in GNMA forwards. At the end of December, however, MM filed for bankruptcy, and has defaulted on these transactions. These defaults resulted in a losses of more than a half million dollars to several dealers, one of which was already experiencing severe cash flow problems and is now the subject of an SEC enforcement action. It appears that MM's depositors will lose approximately $4 million as a result of its insolvency.

Case # 27

JJ is a credit union formed in 1976 to function as a central credit union for several small credit unions. JJ acts primarily as a "reserve bank" for the member credit unions by investing their excess funds and by providing short term loans during periods of heavy demand by its members. In early 1977, during a period of rapid growth, JJ hired a new president and investment manager, who began to invest heavily in GNMA forwards and other government-guaranteed securities through three registered broker-dealers. At two of the firms, JJ's trades were routed through separate, unregistered affiliates of those registered broker-dealers which dealt only in government securities.

JJ's new manager instituted an aggressive "trading strategy," which was designed to take advantage of daily shifts in market prices, and which frequently involved buying and selling the same security several times in the same day. In addition, the manager purchased large amounts of GNMA and FHLMC forward commitments anticipating that increased member deposits would enable JJ to take delivery of these securities on their settlement dates.

Credit union member deposits did not grow as quickly as anticipated, however, and when interest rates began to rise, JJ had commitments to take delivery of large amounts of securities several points above market, but was without sufficient funds to take delivery. In order to postpone delivery of these securities, JJ entered into a series of reverse repo agreements, including

---

6/ MM claims that it never received the letter which the banking commissioner mailed to inform it of the new prohibition on GNMA trading.

dollar price reverse repurchase agreements, 7/ with its dealers, hoping that (1) interest rates would fall and it would be able to resell the securities at a gain or at a smaller loss, or (2) increased member deposits would enable it to take delivery and hold the securities in inventory. This strategy failed because interest rates remained high and member deposits did not increase sufficiently. As a result, state banking authorities had to step in with additional funds to prevent JJ from defaulting on obligations of $5 million coming due in October, 1979, and $18 million coming due in November, 1979. JJ recognized a loss of $1.8 million as a result of these forward commitments.

In the course of its trading in government-guaranteed securities, JJ was dealing with three different dealers, and was doing considerable business with two of them. The dealers contend that JJ and its manager were sophisticated investors, pointing out that JJ had been successful in day trading and that, although it incurred losses from its heavy forward commitments, everyone who had forward commitments in government-guaranteed securities took losses when the interest rates continued to rise. Nevertheless, the sale of forward commitments to JJ may have been unsuitable for that entity. Further, although one of the dealers required JJ to maintain securities with it in a margin account, the others did not. Thus, as a practical matter, there was no limit on the amount of forward commitments on which JJ could be obligated. Despite JJ's very rapid growth, it was still overcommitted to purchase securities in the forward market. Substantial forward commitments such as these exposed the credit union to undue market risk, notwithstanding the apparent sophistication of JJ's manager.

Case #28

An unregistered broker-dealer was created in late 1978 with approximately $4.5 million in capital to deal in government and government-guaranteed securities in a so-called matched book. 8/ During its short existence, the partnership engaged primarily in GNMA repurchase ("repo") and reverse repurchase ("reverse repo") agreements. The partnership consisted of three largely passive partners who provided most of its capital and one active partner who conducted trading and managed operations. Within a year of its inception, the firm did business with hundreds of both sophisticated and unsophisticated investors, including a state, a political subdivision, banks from South Carolina to New York, savings and loan associations, and mortgage bankers.

Approximately six months after the firm was formed, the active partner, apparently without the knowledge of the others, opened the first of three trading accounts for himself under fictitious names. His apparent purpose was to enable himself to trade without having to provide any capital. Six months later the firm declared bankruptcy. These losses were apparently attributable, at least in part, to the three nominee accounts and to unsecured loans made by the broker-dealer to its partners.

Based on a very preliminary information, it appears that the active partner purchased large quantities of securities without sufficient funds with the expectation that interest rates would go down. In addition it appears that the other partners learned of the firm's large trading losses approximately two months before the declaration of bankruptcy, but nevertheless allowed the firm's employees to continue making new commitments during this period.

When the firm declared bankruptcy, it had commitments of approximately $130 million dollars in repo and reverse repo agreements. When the firm declared bankruptcy, its liabilities exceeded its assets by $11.5 million. It is impossible to determine who will eventually suffer the losses, but there were approximately 40 persons which had open positions with the firm when it declared bankruptcy, including registered dealers, unregistered dealers, local governments, and savings and loans associations.

7/ Under these dollar price reverse repurchase agreements, the credit union would fund the purchase of securities by selling them back to the dealers on settlement date and agreeing to repurchase securities with an equivalent yield on a date in the future. The lending dealer could sell or otherwise dispose of the securities it purchased from the credit union, and then was required to obtain securities with an equivalent yield to resell to the credit union upon maturity of the repurchase agreement.

8/ In a matched book, a dealer, acting for its own account, engages in an equal number of purchases and sales of the same securities, thereby limiting its risk and the amount of capital required. Profits are derived chiefly from the spread between the purchase and sale prices and from the differences between the interest rates.

businessmen from duplicative regulation by the various states and the federal government. In view of this purpose, a person who has not submitted to the jurisdiction of this Commission is not entitled to the protection the Commodity Exchange Act would otherwise offer.

It follows that to the extent any state or federal agency would have jurisdiction over certain activities in the absence of the exclusive jurisdiction provision of the Commodity Exchange Act—whether under securities laws or otherwise—that agency may, in our view, assert its jurisdiction against any person who has not taken appropriate action, as required by law, to submit to this agency's exclusive jurisdiction.[3]

Of course, if your client's activities are not such as are subject to regulation under the Commodity Exchange Act—and we make no judgment as to that matter—there would, in any event, be no basis under that Act upon which your client may dispute the authority of the SEC. On the other hand, even if your client should be engaged in activities that would subject it to our exclusive jurisdiction, it has not, in fact, sought registration with this Commission as a futures commission merchant. Thus, it has not submitted itself to the jurisdiction of this agency. In this circumstance, for reasons noted above, we perceive no basis why the Securities and Exchange Commission should not be entitled to seek appropriate forms of relief for those of your client's activities it considers within the scope of the federal securities laws.

[¶ 20,467] CFTC Interpretative Letter No. 77-12 (Dealers in GNMA Certificates as Board of Trade).

Commodity Futures Trading Commission, Office of General Counsel. August 17, 1977. Letter in full text.

Board of Trade—Definition—Dealers in GNMA Certificates—CFTC Jurisdiction.— Dealers in GNMA certificates may be within the jurisdiction of the Commodity Futures Trading Commission when their forward contracts lose their essentially private nature and they concern the public. Given the circumstances in a request for an interpretation, the staff believed that the activities of a dealer in GNMA certificates did not concern contracts of sale of a commodity for future delivery traded or executed on a board of trade. However, the loose network of dealers may be operating as a board of trade despite their intentions.

See ¶ 4150, "Definitions" division; and ¶ 5001, "Commodity Futures Trading Commission" division.

Dear Mr.

This is in response to your letter of April 27, 1977, which we understand to request our views on whether certain present and proposed activities of your client, DEF ("Company"), are those of a participant in transactions involving contracts of sale of a commodity for future delivery, traded or executed on a board of trade, within the meaning of the Commodity Exchange Act, as amended (the "Act"), 7 U. S. C. 1 et seq. (Supp. V, 1975).

From your letter and a telephone conversation with this Office on May 9, 1977, we understand that the Company, through different subsidiaries, engages and proposes to engage in the business of buying and selling various United States Government securities as a broker. At the present time one subsidiary buys and sells Government National Mortgage Association obligations ("GNMAs") in both the cash market and in what you term the "forward market." It is contemplated that another subsidiary will buy and sell United States Treasury Bills, Treasury Notes and Treasury Bonds (collectively "Treasury Obligations") in what you term the "forward market."

---

[3] Any prospective injunctive or other relief obtained by another agency in this circumstance could not be interpreted or applied, however, in a manner conflicting with the Commodity Exchange Act or with lawful regulations that this agency might thereafter impose. See *Minnesota v. Coin Wholesalers, Inc.*, CCH Comm. Fut. L. Rep. ¶ 20,247 (Minn. S. Ct., December 30, 1976). *Cf., e.g., Securities and Exchange Commission v. American Commodity Exchange, Inc., supra* n. 3, 546 F. 2d at p. 1367 n. 1:

"... [S]o long as the exclusive jurisdiction of the Commodity Commission is fully recognized, the jurisdiction of the Securities and Exchange Commission which does not impair or undermine the authority of the Commodity Commission within its field is entirely proper."

At present, the subsidiary buying and selling GNMAs obtains bid and asked prices from primary dealers in GNMAs, buys from the asking primary dealer who most closely matches the bid price and immediately sells to the bidding primary dealer who most closely matches the asked price. Neither primary dealer in the transaction is aware of the identity of the other primary dealer. Settlement is effected through a bank which does not assume liability for a dealer's obligations. Other brokers use other means to settle accounts, none of which involves the substitution of the dealer or the assumption of its obligations. Contract terms and conditions, such as quantity, price and delivery date, are negotiated for each transaction, although standardized delivery dates may evolve. Payment and delivery are required on the date negotiated and delivery is anticipated in each transaction and occurs in virtually all transactions. The subsidiary charges a standard markup as its commission to effect the transaction. The proposed transactions in Treasury Obligations will be effected by the other subsidiary in essentially the same manner as that described above.

In the case of the GNMA transactions, the subsidiary deals only with members of the GNMA Mortgage Backed Securities Dealer Association, a group of approximately 42 organizations, including banks and securities dealers. In the contemplated transactions in Treasury Obligations, the subsidiary will deal only with those organizations with which the Federal Reserve Bank, through its Open-Market Committee, directly trades U. S. Government and agency obligations, as well as organizations then being considered by the Open-Market Committee as candidates for direct trading status. At present there are approximately 37 of these organizations, almost all of whom are also members of the GNMA Mortgage Backed Securities Dealer Association.

You have concluded that the transactions in GNMAs and the proposed transactions in Treasury Obligations are not transactions involving contracts of sale of a commodity for future delivery within the meaning of the Act. In this connection you have analyzed and called to our attention the section entitled "A Comparison of Some Significant Elements of Future Contracts, Forward Contracts and Leverage Contracts", contained in the Report of the Commission's Advisory Committee on Market Instruments on "Recommended Policies on Futures, Forward and Leverage Contracts and Transactions" (July 16, 1976).[1] In your analysis, you have referred to various elements which you represent exist in the GNMA and proposed Treasury Obligations transactions that distinguish those transactions from transactions involving contracts of sale of a commodity for future delivery. Those elements include the privately-negotiated terms of the contracts, the lack of standardized contract terms, the lack of public outcry to establish price, the fact that delivery is anticipated in connection with each purchase and sale, the lack of a clearing house that becomes the buyer to each seller and the seller to each buyer, and the fact that only members of the trade participate in the transactions with no participation by members of the public.

Information has come to our attention that indicates that members of the GNMA Mortgaged Backed Securities Dealer Association sell GNMAs to their customers, such as banks, savings and loan associations and credit unions, both on a cash basis and on a future commitment basis, and may hedge their commitments by use of the transactions that you describe in your letter. It would thus appear that these customers may be at least indirectly participating in these transactions.

In our view, whether any transactions involve contracts of sale of a commodity for future delivery, traded or executed on a board of trade requires an examination of the terms and conditions of the contracts involved, the nature of the persons participating in the transactions, the functions served or to be served by the contract, and the marketplace and the manner in which the transactions are effected. Of course, these factors must be viewed in the context of the provisions of the Act, as they have been enacted or amended from time to time, and the legislative history of those provisions.

Section 2(a)(1) of the Act defines a "contract of sale" to include sales, agreements

[1] That Report contained proposals concerning transactions subject to Commission regulation under Section 217 of the Commodity Futures Trading Commission Act of 1974, 7 U.S.C. § 15a (Supp. V, 1975). Among other things, Section 217 provides that if the Commission determines that any such transaction is a contract for future delivery within the meaning of the Commodity Exchange Act, the transaction shall be regulated in accordance with the provisions of that Act.

of sale and agreements to sell and a "board of trade" to include any exchange or association of persons ". . . who shall be engaged in the business of buying or selling any commodity or receiving the same for sale on consignment." The term "contract of sale of a commodity for future delivery" is not defined in the Act, but its plain meaning is clearly broad enough to encompass any contracts to market a commodity, the terms of which are privately negotiated between the buyer and the seller, with payment for and delivery of the commodity expected to occur some time in the future—contracts that are commonly described as forward contracts.

As early as 1921, however, Congress indicated that those contracts of sale of a commodity for future delivery that it intended to be fully regulated are defined not only by the element of deferred shipment but also by the nature of the marketplace in which a buyer and seller entered into the contract. At that time, Congress enacted the Future Trading Act and provided in Section 2 of that Act that the term "future delivery" did not include ". . . any sale of cash grain for deferred shipment or delivery."[2] The legislative history of this ambiguous provision evidences a Congressional desire to exclude from the taxing provisions of the Future Trading Act essentially private transactions conducted off a board of trade. Viewed in this context, the thrust of the provision is toward the marketplace in which the transaction occurs rather than the element of deferred shipment.[3]

In view of these considerations, when so-called forward contracts are traded by a group of persons whose activities bring them within the definition of a board of trade, the contracts may, as a consequence, lose their essentially private nature and come within the category of contracts for future delivery with which the Act is primarily concerned. Thus, Section 3 of the Commodity Exchange Act sets forth a Congressional determination that transactions involving the sale of commodities for future delivery as commonly conducted on boards of trade and known as "futures" are affected with a national public interest and that those transactions are carried on in large volume by the public generally and by persons engaged in the business of buying and selling commodities and their products and byproducts in interstate commerce.

The foregoing considerations apply no less to the transactions in GNMAs and Treasury Obligations that you describe than to trading with respect to any other interest within the statutory definition of a commodity. Section 2(a)(1) of the Act defines the term "commodity" to include, in addition to specifically enumerated agricultural commodities, ". . . all other goods and articles, except onions . . . and all services, rights, and interests in which contracts for future delivery are presently or in the future dealt in . . . ." Thus, the definition of "commodity" includes rights and interests which may be securities for purposes of the securities laws.[4] Indeed, Section 2(a)(1) of the Act specifically provides that the Act does not apply to "transactions in . . . government securities . . . unless such transactions involve the sale thereof for future delivery conducted on a board of trade."

The network of primary dealers that you describe in your letter may come within the Act's broad definition of a board of trade, in which event their GNMA activities may subject them to regulation under the Act.

[2] 42 Stat. 187 (1921). This provision was reenacted without change as part of the Grain Futures Act, 42 Stat. 998 (1922), and, as amended, to refer to "any cash commodity," was enacted as part of the Commodity Exchange Act, 49 Stat. 1491 (1936). The provision presently appears in Section 2(a)(1) of the Act.

[3] 42 Stat. 197 (1921). In the form considered by the Senate Committee on Agriculture and Forestry, Section 4 of H.R. 5676, the bill that became the Future Trading Act, imposed a 20 cent per bushel tax on each contract of of sale of grain for future delivery ". . . made at, on, or in an exchange, board of trade, or similar institution or place of business." There were certain exceptions to the taxing provision, including an exception where the contracts were made by or through a member of a board of trade that was designated as a contract market. The language quoted above was added by the House so that any grower or dealer who might sell grain for deferred shipment would not be liable to the tax. However, in enacting H.R. 5676, Congress adopted the recommendation of the Committee to delete this language from Section 4 and to add to Section 2 of the bill the provision to exclude from the term "future delivery", any sale of cash grain for deferred shipment or delivery. The following explanation accompanied the Committee's recommendation:

> ". . . with the addition of the sentence in Section 2 . . . [the tax consequences to growers or dealers] would not obtain. It is obvious also that if these words [in Section 4] remain in the bill operations on private exchanges or bucket shops would be possible." S. Rep. No. 212, 67th Cong. 1st Sess. 1. (1921).

[4] H. Rep. No. 975, 93d Cong. 2d Sess. 28-29 (1974).

The fact that a particular association of persons does not choose to characterize itself as a "board of trade" is, of course, not dispositive of whether, for purposes of the Act, a board of trade exists.

We recognize that Congress was aware of existing dealer markets in government securities as well as other financial instruments at the time it enacted the Commodity Futures Trading Commission Act of 1974, which, among other things, amended Section 2(a)(1) of the Act to grant to the Commission exclusive jurisdiction over transactions involving contracts of sale of a commodity for future delivery traded on any board of trade. In discussing that part of Section 2(a)(1) relating to government securities (among other things), the Senate Committee on Agriculture and Forestry commented that it had included

> "... an amendment [to the House bill] to clarify that the provisions of the bill are not applicable to trading in foreign currencies and certain enumerated financial instruments unless such trading is conducted on a formally organized futures exchange. A great deal of trading in foreign currency in the United States is carried out through an informal network of banks and tellers. The Committee believes that this market is more properly supervised by the bank regulatory agencies and that, therefore, regulation under this legislation is unnecessary.
> "Likewise, the Committee believes that regulation by the Commission of transactions in the specified financial instruments (i. e., security warrants, security rights, resales of installment loan contracts, repurchase options, government securities, mortgages and mortgage purchase commitments), which generally are between banks and other sophisticated institutional participants, is unnecessary, unless executed on a formally organized futures exchange." S. Rep. No. 1131, 93d Cong., 2d Sess. 23 (1974).

We view these remarks by the Committee as an expression that regulation by the Commission is unnecessary where there exists an informal market among institutional participants in transactions for future delivery in the specified financial instruments only so long as it is supervised by those agencies having regulatory responsibility over those participants. However, where that market is not supervised and where those transactions are conducted with participation by members of the general public, we do not understand the Committee to have intended that a regulatory gap should exist. In these circumstances, we believe the Commodity Exchange Act should be construed broadly to assure that the public interest will be protected by Commission regulation of those transactions.

Notwithstanding these considerations, on the basis of the facts concerning your client's existing and proposed transactions in GNMAs and Treasury Obligations as set forth in your letter, particularly the lack of general public participation in the transactions, it may be reasonable to conclude, as you appear to have concluded, that your client's transactions do not involve contracts of sale of a commodity for future delivery traded or executed on a board of trade. If you should be misinformed concerning any material fact, however, for example, the lack of public participation in the transactions, a different conclusion may be required.

The legal issues involved are to some extent novel and we are not certain whether the facts you have supplied or are in a position to supply are adequate to make a definitive judgment concerning them. In these circumstances, particularly since we are aware of facts tending to show that some firms may have been committing fraud in connection with the sale of GNMAs, and we have no way at this time to determine for ourselves—even with your help—all the relevant facts concerning trading in GNMAs by your client and others, we are reluctant to express an opinion concerning your client's activities.

§ 703.3 Investment activities.

(a) *Definitions.* (1) "Security" means any investment or deposit authorized for a Federal credit union pursuant to sections 107(7) and 107(8) of the Act. For the purpose of this section, the definition of a security shall not mean loans to members or loans authorized under §§ 701.21-6 and 701.21-8 of the rules and regulations.

(2) "Standby commitment" means an agreement to purchase or sell a security at a future date, whereby the buyer is required to accept delivery of the security at the option of the seller.

(3) "Cash forward agreement" means an agreement to purchase or sell a security, at a future date, that requires mandatory delivery and acceptance. The contract for the purchase or sale of a security for which delivery of the security is made in excess of thirty (30) days but not exceeding one hundred and twenty (120) days from the trade date shall be considered to be a cash forward agreement.

(4) "Repurchase transaction" means a transaction in which a Federal credit union agrees to purchase a security from a vendor and to resell a security to that vendor at a later date. A repurchase transaction may be of two types:

(i) "Investment-type repurchase transaction" means a repurchase transaction where:

(A) The Federal credit union purchasing the security takes physical possession of the security, or receives written confirmation of the purchase and a custodial or safekeeping receipt from a third party bank or other financial institution under a written bailment for hire contract identifying a specific security in its possession as owned by the Federal credit union;

(B) There is no restriction on the transfer of the security purchased by the Federal credit union; and

(C) The Federal credit union is not required to deliver the identical security to the vendor upon resale.

(ii) "Loan-type repurchase transaction" means any repurchase transaction that does not qualify as an investment-type repurchase transaction. A loan-type repurchase transaction represents a lending transaction and is subject to the limitations of section 107(5) of the Act.

(5) "Reverse repurchase transaction" means a transaction whereby a Federal credit union agrees to sell a security to a purchaser and to repurchase the same security from that purchaser at a future date, irrespective of the amount of consideration paid by the Federal credit union or the purchaser. A reverse repurchase transaction represents a borrowing transaction and is subject to the limitations of section 107(9) of the Act.

(6) "Futures contract" means a standardized contract for the future delivery of commodities, including certain government securities, sold on designated commodities exchanges.

(7) "Trade date" means the date a Federal credit union originally agreed, whether verbally or in writing, to enter into the purchase or sale of a security with a vendor.

(8) "Settlement date" means the date originally agreed to by a Federal credit union and a vendor for settlement of the purchase or sale of a security, without any modification or extension of that date.

(9) "Maturity date" means the date on which a security matures, and shall not mean the call date or the average life of the security.

(10) "Adjusted trading" means any method or transaction used to defer a loss whereby a Federal credit union sells a security to a vendor at a price above its current market price and si-

multaneously purchases or commits to purchase from that vendor another security above its current market price.

(11) "Bailment for hire contract" means a contract whereby a third party bank or other financial institution for a fee agrees to exercise ordinary care in protecting the securities held in safekeeping for its customers.

(12) "Short sale" means the sale of a security not owned by the seller.

(13) "Market price" means the last established price at which a security is sold.

(b) *Limitations.* (1) A Federal credit union may contract for the purchase or sale of a security authorized by section 107(7) of the Act, provided that the delivery of the security is to be made within thirty (30) days from the trade date.

(2) A Federal credit union may not enter into a standby commitment to purchase or sell a security.

(3) A Federal credit union may enter into a cash forward agreement to purchase a security provided that the period from the trade date to the settlement date does not exceed one hundred and twenty (120) days and the credit union has written cash flow projections evidencing its ability to purchase the underlying security. A Federal credit union may not enter into a cash forward agreement to sell a security unless it presently owns the security. All cash forward agreements must be settled on a cash basis at the settlement date.

(4) A Federal credit union may not enter into an investment-type repurchase transaction unless all the conditions cited in § 703.3(a)(4)(A) are met. Any repurchase transaction that does not meet such requirements constitutes a loan-type repurchase transaction subject to the limitations of § 703.3(b)(5). The purchase price of a security obtained under an investment-type repurchase transaction must be at the market price.

(5) A Federal credit union may enter into a loan-type repurchase transaction only with its own members, other credit unions, or approved credit union organizations that are defined in § 701.27-2 of the rules and regulations.

(6) A Federal credit union may enter into a reverse repurchase transaction, provided that the funds obtained are not invested under section 107(7)(I) of the Act. Furthermore, either any investment or deposit made under sections 107(7) (B), (D), (E), (F), (G), (H) or 107(8) of the Act or any security collateralizing the reverse repurchase transaction must have a maturity date not later than the settlement date for the reverse repurchase transaction. The maximum amount of funds that may be borrowed under a reverse repurchase transaction for investment or deposit is 10 percent of paid-in and unimpaired capital and surplus.

(7) A Federal credit union may not buy or sell a futures contract unless the purchase or sale is specifically authorized by a regulation issued by the Administration.

(8) A Federal credit union may not engage in adjusted trading as defined in § 703.3(a)(10).

(9) A Federal credit union may not engage in a short sale as defined in § 703.3(a)(12).

(10) All purchases and sales of securities by a Federal credit union by means of a cash transaction under § 703.3(b)(1) or a cash forward agreement under § 703.3(b)(3) must be at the market price.

(Sec. 107, 91 Stat. 49 (12 U.S.C. 1757), sec. 120, 73 Stat. 635 (12 U.S.C. 1766) and sec. 209, 84 Stat. 1104 (12 U.S.C. 1789))

[44 FR 42676, June 20, 1979]

and will promptly deliver it upon exercise of the option.

(b) For the purposes of this section, a person shall be deemed to own a security if (1) he or his agent has title to it; or (2) he has purchased, or has entered into an unconditional contract, binding on both parties thereto, to purchase it but has not yet received it; or (3) he owns a security convertible into or exchangeable for it and has tendered such security for conversion or exchange; or (4) he has an option to purchase or acquire it and has exercised such option; or (5) he has rights or warrants to subscribe to it and has exercised such rights or warrants: *Provided, however,* That a person shall be deemed to own securities only to the extent that he has a net long position in such securities.

(Sec. 10, 48 Stat. 891; 15 U.S.C. 78j)

[33 FR 8269, June 4, 1968]

§ 240.10b–5 Employment of manipulative and deceptive devices.

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

(Sec. 10; 48 Stat. 891; 15 U.S.C. 78j)

[13 FR 8183, Dec. 22, 1948, as amended at 16 FR 7928, Aug. 11, 1951]

§ 240.10b–6 Prohibitions against trading by persons interested in a distribution.

(a) It shall constitute a "manipulative or deceptive device or contrivance" as used in section 10(b) of the act for any person,

(1) Who is an underwriter or prospective underwriter in a particular distribution of securities, or

(2) Who is the issuer or other person on whose behalf such a distribution is being made, or

(3) Who is a broker, dealer, or other person who has agreed to participate or is participating in such a distribution, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange, either alone or with one or more other persons, to bid for or purchase for any account in which he has a beneficial interest, any security which is the subject of such distribution, or any security of the same class and series, or any right to purchase any such security, or to attempt to induce any person to purchase any such security or right, until after he has completed his participation in such distribution: *Provided, however,* That this section shall not prohibit:

(i) Transactions in connection with the distribution effected otherwise than on a securities exchange with the issuer or other person or persons on whose behalf such distribution is being made or among underwriters, prospective underwriters, or other persons who have agreed to participate or are participating in such distribution,

(ii) Unsolicited privately negotiated purchases, each involving a substantial amount of such security, effected neither on a securities exchange nor from or through a broker or dealer, or

(iii) Purchases by an issuer effected more than forty days after the commencement of the distribution for the purpose of satisfying a sinking fund or similar obligation to which it is subject, or

(iv) Odd-lot transactions (and the offsetting round-lot transactions hereinafter referred to) by a person registered as an odd-lot dealer in such security on a national securities exchange who offsets such odd-lot transactions in such security by round-lot transactions as promptly as possible, or

(v) Brokerage transactions not involving solicitation of the customer's order, or

the payment of debts over all other creditors. In re Standard Oak Veneer Co., D.C.Tenn.1909, 173 F. 103.

6. Jurisdiction

A national bank should be considered as a "citizen" of state where it has its principal place of business irrespective of fact that it has authorized branches in other states, and hence Oregon District Court had jurisdiction on ground of "diversity of citizenship", of action against California national bank which maintained a branch in Oregon, since the bank would be viewed as a citizen of California. American Surety Co. of New York v. Bank of California, D.C.Or.1941, 44 F.Supp. 81, affirmed 133 F.2d 160.

This section and section 81 of this title contemplate that a national bank shall have situs in one state and that jurisdiction of a federal court attaches under the ordinary rules as to diversity of citizenship based on that assumption and federal jurisdiction is no longer based upon the fact of federal incorporation of a bank, intent of this section and section 81 of this title being to steer a middle course and to confer upon a national bank the right to come into or remove a cause to a federal court in common with private corporations invested with powers by the several states. Id.

7. Pleading

See, also, Notes of Decisions under section 24 of this title.

Allegation of organization, see Third Nat. Bank of Baltimore v. Teal, C.C.Md. 1881, 5 F. 503.

Allegation of place of business, see Farmers' & Mechanics' Nat. Bank of Buffalo v. Rogers, 1888, 1 N.Y.S. 737.

8. Proof

A state court will take judicial notice of the general laws of the United States, and such being the fact it is competent for an association to prove by parol that it is carrying on a general banking business as a national bank authorized by the general laws of the United States under the name by which it sues. Yakima Nat. Bank v. Knipe, 1893, 6 Wash. 348, 33 P. 834, followed in National Bank of Commerce v. Galland, 1896, 14 Wash. 502, 45 P. 35.

Corporate existence may be proved by parol evidence. Farmers' Nat. Bank v. Johnston, Okl.1918, 176 P. 226, 3 A.L.R. 99.

The certificate of organization is competent evidence of the incorporation. National Bank of Commerce v. Galland, 1896, 45 P. 35, 14 Wash. 502.

9. Estoppel

When person is estopped to deny validity of organization, see Casey v. Galli, 1876, 94 U.S. 674, 24 L.Ed. 168; Davis' Estate v. Watkins, 1898, 76 N.W. 575, 56 Neb. 288; Keyser v. Hitz, 1883, 2 (13 D.C.) Mackey 473; National Bank of Fairhaven v. Phœnix Warehousing Co., N.Y. Sup.1875, 6 Hun, 71; Bank of Metropolis v. Orcutt, N.Y.Sup.1867, 48 Barb. 256; Huffaker v. Nat. Bank of Monticello, 1876, 75 Ky. 287; Wheelock v. Kost, 1875, 77 Ill. 296.

10. Collateral attack

The validity of a national bank's incorporation is not open to collateral attack by the stockholder, whose liability the receiver seeks to enforce. Weitzel v. Brown, 1916, 112 N.E. 945, 224 Mass. 190.

§ 23. Acknowledgment and filing of certificate

The organization certificate shall be acknowledged before a judge of some court of record, or notary public; and shall be, together with the acknowledgment thereof, authenticated by the seal of such court, or notary, transmitted to the Comptroller of the Currency, who shall record and carefully preserve the same in his office. R.S. § 5135.

Historical Note

Derivation. R.S. § 5135 was from Act June 3, 1864, c. 106, § 6, 13 Stat. 101, which was the National Bank Act. See section 38 of this title.

§ 24. Corporate powers of associations

Upon duly making and filing articles of association and an organization certificate a national banking association shall become, as from the date of the execution of its organization certificate, a body corporate, and as such, and in the name designated in the organization certificate, it shall have power—

First. To adopt and use a corporate seal.

Second. To have succession from February 25, 1927, or from the date of its organization if organized after February 25, 1927, until such time as it be dissolved by the act of its shareholders owning two-thirds of its stock, or until its franchise becomes forfeited by reason of violation of law, or until terminated by either a general or a special Act of Congress or until its affairs be placed in the hands of a receiver and finally wound up by him.

Third. To make contracts.

Fourth. To sue and be sued, complain and defend, in any court of law and equity, as fully as natural persons.

Fifth. To elect or appoint directors, and by its board of directors to appoint a president, vice president, cashier, and other officers, define their duties, require bonds of them and fix the penalty thereof, dismiss such officers or any of them at pleasure, and appoint others to fill their places.

Sixth. To prescribe, by its board of directors, by-laws not inconsistent with law, regulating the manner in which its stock shall be transferred, its directors elected or appointed, its officers appointed, its property transferred, its general business conducted, and the privileges granted to it by law exercised and enjoyed.

Seventh. To exercise by its board of directors or duly authorized officers or agents, subject to law, all such incidental powers as shall be necessary to carry on the business of banking; by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; by receiving deposits; by buying and selling exchange, coin, and bullion; by loaning money on personal security; and by obtaining, issuing, and circulating notes according to the provisions of this chapter. The business of dealing in securities and stock by the association shall be limited to purchasing and selling such securities and stock without recourse, solely upon the order, and for the account of, customers, and in no case for its own account, and the association shall not underwrite any issue of securities or stock: *Provided*, That the association may purchase for its own account investment securities under such limitations and restrictions as the Comptroller of the Currency may by regulation prescribe. In no event shall the total amount of the investment securities of any one obligor or maker, held by the association for its own account, exceed at any time 10 per centum of its capital stock actually paid in and unimpaired and 10 per centum of its unimpaired surplus fund, except that this limitation shall not require any association to dispose of any securities lawfully held by it on August 23, 1935. As used in this section the term "investment securities" shall mean marketable obligations, evidencing indebtedness of any person, copartnership, association, or corporation in the form of bonds, notes and/or debentures commonly known as investment securities under such further definition of the term "investment securities" as may by regulation be prescribed by the Comptroller of the Currency. Except as hereinafter provided or otherwise permit-

ted by law, nothing herein contained shall authorize the purchase by the association for its own account of any shares of stock of any corporation. The limitations and restrictions herein contained as to dealing in, underwriting and purchasing for its own account, investment securities shall not apply to obligations of the United States, or general obligations of any State or of any political subdivision thereof, or obligations issued under authority of subchapters I, II, and III of chapter 7 of this title, or issued by the Federal Home Loan Banks or the Home Owners' Loan Corporation, or obligations which are insured by the Federal Housing Administrator pursuant to section 1713 of this title, if the debentures to be issued in payment of such insured obligations are guaranteed as to principal and interest by the United States, or obligations of national mortgage associations: *Provided*, That in carrying on the business commonly known as the safe-deposit business the association shall not invest in the capital stock of a corporation organized under the law of any State to conduct a safe-deposit business in an amount in excess of 15 per centum of the capital stock of the association actually paid in and unimpaired and 15 per centum of its unimpaired surplus.

Eighth. To contribute to community funds, or to charitable, philanthropic, or benevolent instrumentalities conducive to public welfare, such sums as its board of directors may deem expedient and in the interests of the association, if it is located in a State the laws of which do not expressly prohibit State banking institutions from contributing to such funds or instrumentalities. R.S. § 5136; July 1, 1922, c. 257, § 1, 42 Stat. 767; Feb. 25, 1927, c. 191, § 2, 44 Stat. 1226; June 16, 1933, c. 89, § 16, 48 Stat. 184; Aug. 23, 1935, c. 614, § 308, 49 Stat. 709; Feb. 3, 1938, c. 13, § 13, 52 Stat. 26; June 11, 1940, c. 301, 54 Stat. 261.

Historical Note

References in Text. Words "this chapter" in paragraph Seventh, see Historical Note under section 21 of this title.

1922 Amendment. Act July 1, 1922, cited to text, among other changes in paragraph Second, extended period of succession.

1927 Amendment. Act Feb. 25, 1927, cited to text, omitted definite period of succession in paragraph Second and added proviso clauses in paragraph Seventh.

1933 Amendment. Act June 16, 1933, cited to text, among other changes, omitted former closing paragraph prohibiting transaction of any business by association prior to authorization by Comptroller, except that necessarily preliminary to organization.

1935 Amendment. Act Aug. 23, 1935, cited to text, amended second, fourth, and last sentences of paragraph Seventh.

1938 Amendment. Act Feb. 3, 1938, cited to text, inserted "or obligations of national mortgage associations", in last sentence of paragraph Seventh.

1940 Amendment. Act June 11, 1940, cited to text, added paragraph Eighth.

Effective Date. Act June 16, 1933, cited to text, provided that restrictions of this section as to dealing in investment securities should take effect one year after June 16, 1933.

Derivation. R.S. § 5136, was from Act June 3, 1864, c. 106, § 8, 13 Stat. 101, which was the National Bank Act. See section 38 of this title.

Extension of corporate succession. Provisions for the extension of the corporate succession of national banks were made by Act July 12, 1882, c. 290, § 1, 22 Stat. 162, and Act Apr. 12, 1902, c. 503, 32 Stat. 102.

of official travel within the corporate limits of their official stations for the purpose of examining, supervising, or servicing Federal credit unions located within said corporate limits, may be reimbursed for such travel at a rate not to exceed 3 cents per mile.

July 22, 1942, c. 516, § 1, 56 Stat. 700; 1947 Reorg.Plan No. 1, § 401, eff. July 1, 1947, 12 F.R. 4534, 61 Stat. 952; June 29, 1948, c. 711, §§ 1, 2, 62 Stat. 1091.

Historical Note

Codification. Section was not enacted as part of the Federal Credit Union Act, which comprises this chapter.

Transfer of Functions. Transfer of functions of Bureau of Federal Credit Unions and the Director thereof to the National Credit Union Administration and the Board thereof, see section 1752a of this title and notes thereunder.

Transfer of functions of Farm Credit Administration and the Governor thereof, see notes under section 1751 of this title.

In text of this section, "Federal Deposit Insurance Corporation" was substituted for "Farm Credit Administration" by 1947 Reorg.Plan No. 1. See note under section 1751 of this title.

Exceptions from Transfer of Functions. Functions of the Corporations of the Department of Agriculture, the boards of directors and officers of such corporations; the Advisory Board of the Commodity Credit Corporation; and the Farm Credit Administration or any agency, officer or entity of, under, or subject to the supervision of the Administration were excepted from the functions of officers, agencies and employees transferred to the Secretary of Agriculture by 1953 Reorg.Plan No. 2, § 1, eff. June 4, 1953, 18 F.R. 3219, 67 Stat. 633, set out in Appendix to Title 5, Government Organization and Employees.

Legislative History. For legislative history and purpose of Act June 29, 1948, see 1948 U.S.Code Cong.Service, p. 2172.

§ 1757. Powers

A Federal credit union shall have succession in its corporate name during its existence and shall have power—

(1) to make contracts;

(2) to sue and be sued;

(3) to adopt and use a common seal and alter the same at pleasure;

(4) to purchase, hold, and dispose of property necessary or incidental to its operations;

(5) to make loans, the maturities of which shall not exceed twelve years except as otherwise provided herein, and extend lines of credit to its members, to other credit unions, and to credit union organizations and to participate with other credit unions, credit union organizations, or financial organizations in making loans to credit union members in accordance with the following:

(A) Loans to members shall be made in conformity with criteria established by the board of directors: *Provided*, That—

(i) a residential real estate loan which is made to finance the acquisition of a one-to-four-family dwelling,

including an individual cooperative unit, for the principal residence of a credit union member, the sales price of which is not more than 150 per centum of the median sales price of residential real property situated in the geographical area (as determined by the board of directors) in which the property is located, and which is secured by a first lien upon such dwelling, may have a maturity not exceeding thirty years (except that a loan on an individual cooperative unit shall be adequately secured as defined by the Board), subject to the rules and regulations of the Board;

(ii) a loan to finance the purchase of a mobile home, which shall be secured by a first lien on such mobile home, to be used by the credit union member as his residence, or for the repair, alteration, or improvement of a residential dwelling which is the residence of a credit union member shall have a maturity not to exceed fifteen years unless such loan is insured or guaranteed as provided in subparagraph (iii);

(iii) a loan secured by the insurance or guarantee of the Federal Government, of a State government, or any agency of either may be made for the maturity and under the terms and conditions specified in the law under which such insurance or guarantee is provided;

(iv) a loan or aggregate of loans to a director or member of the supervisory or credit committee of the credit union making the loan which exceeds $5,000 plus pledged shares, be approved by the board of directors;

(v) loans to other members for which directors or members of the supervisory or credit committee act as guarantor or endorser be approved by the board of directors when such loans standing alone or when added to any outstanding loan or loans of the guarantor or endorser exceeds $5,000;

(vi) the rate of interest may not exceed 15 per centum per annum on the unpaid balance inclusive of all finance charges, except that the Board may establish—

(I) after consultation with the appropriate committees of the Congress, the Department of Treasury, and the Federal financial institution regulatory agencies, an interest rate ceiling exceeding such 15 per centum per annum rate, for periods not to exceed 18 months, if it determines that money market interest rates have risen over the preceding six-month period and that prevailing interest rate levels threaten the safety and soundness of individual credit unions as evidenced by adverse

trends in liquidity, capital, earnings, and growth; and

(II) a higher interest rate ceiling for Agent members of the Central Liquidity Facility in carrying out the provisions of subchapter III of this chapter for such periods as the Board may authorize;

(vii) the taking, receiving, reserving, or charging of a rate of interest greater than is allowed by this paragraph, when knowingly done, shall be deemed a forfeiture of the entire interest which the note, bill, or other evidence of debt carries with it, or which has been agreed to be paid thereon. If such greater rate of interest has been paid, the person by whom it has been paid, or his legal representatives, may recover back from the credit union taking or receiving the same, in an action in the nature of an action of debt, the entire amount of interest paid; but such action must be commenced within two years from the time the usurious collection was made;

(viii) a borrower may repay his loan, prior to maturity in whole or in part on any business day without penalty;

(ix) loans shall be paid or amortized in accordance with rules and regulations prescribed by the Board after taking into account the needs or conditions of the borrowers, the amounts and duration of the loans, the interests of the members and the credit unions, and such other factors as the Board deems relevant.

(B) A self-replenishing line of credit to a borrower may be established to a stated maximum amount on certain terms and conditions which may be different from the terms and conditions established for another borrower.

(C) Loans to other credit unions shall be approved by the board of directors.

(D) Loans to credit union organizations shall be approved by the board of directors and shall not exceed 1 per centum of the paid-in and unimpaired capital and surplus of the credit union. A credit union organization means any organization as determined by the Board, which is established primarily to serve the needs of its member credit unions, and whose business relates to the daily operations of the credit unions they serve.

(E) Participation loans with other credit unions, credit union organizations, or financial organizations shall be in accordance with written policies of the board of directors:

Provided, That a credit union which originates a loan for which participation arrangements are made in accordance with this subsection shall retain an interest of at least 10 per centum of the face amount of the loan.

(6) to receive from its members, from other credit unions, from an officer, employee, or agent of those nonmember units of Federal, Indian tribal, State, or local governments and political subdivisions thereof enumerated in section 1787 of this title and in the manner so prescribed, from the Central Liquidity Facility, and from nonmembers in the case of credit unions serving predominately low-income members (as defined by the Board) payments on—

(A) shares which may be issued at varying dividend rates;

(B) share certificates which may be issued at varying dividend rates and maturities; and

(C) share draft accounts authorized under section 1785(f) of this title;

subject to such terms, rates, and conditions as may be established by the board of directors, within limitations prescribed by the Board.

(7) to invest its funds (A) in loans exclusively to members; (B) in obligations of the United States of America, or securities fully guaranteed as to principal and interest thereby; (C) in accordance with rules and regulations prescribed by the Board, in loans to other credit unions in the total amount not exceeding 25 per centum of its paid-in and unimpaired capital and surplus; (D) in shares or accounts of savings and loan associations or mutual savings banks, the accounts of which are insured by the Federal Savings and Loan Insurance Corporation or the Federal Deposit Insurance Corporation; (E) in obligations issued by banks for cooperatives, Federal land banks, Federal intermediate credit banks, Federal home loan banks, the Federal Home Loan Bank Board, or any corporation designated in section 846 of Title 31 as a wholly owned Government corporation; or in obligations, participations, or other instruments of or issued by, or fully guaranteed as to principal and interest by, the Federal National Mortgage Association or the Government National Mortgage Association; or in mortgages, obligations, or other securities which are or ever have been sold by the Federal Home Loan Mortgage Corporation pursuant to section 1454 or 1455 of this title; or in obligations or other instruments or securities of the Student Loan Marketing Association; (F) in participation certificates evidencing beneficial interests in obligations, or in the right to receive interest and principal collections therefrom, which obligations have been subjected by one or more Government agencies to a trust

or trusts for which any executive department, agency, or instrumentality of the United States (or the head thereof) has been named to act as trustee; (G) in shares or deposits of any central credit union in which such investments are specifically authorized by the board of directors of the Federal credit union making the investment; (H) in shares, share certificates, or share deposits of federally insured credit unions; (I) in the shares, stocks, or obligations of any other organization, providing services which are associated with the routine operations of credit unions, up to 1 per centum of the total paid in and unimpaired capital and surplus of the credit union with the approval of the Board: *Provided, however,* That such authority does not include the power to acquire control directly or indirectly, of another financial institution, nor invest in shares, stocks or obligations of an insurance company, trade association, liquidity facility or any other similar organization, corporation, or association, except as otherwise expressly provided by this chapter; and (J) in the capital stock of the National Credit Union Central Liquidity Facility;

(8) to make deposits in national banks and in State banks, trust companies, and mutual savings banks operating in accordance with the laws of the State in which the Federal credit union does business, and for Federal credit unions or credit unions authorized by the Department of Defense operating suboffices on American military installations in foreign countries or trust territories of the United States to maintain demand deposit accounts in banks located in those countries or trust territories, subject to such regulations as may be issued by the Board and provided such banks are correspondents of banks described in this paragraph;

(9) to borrow, in accordance with such rules and regulations as may be prescribed by the Board, from any source, in an aggregate amount not exceeding, except as authorized by the Board in carrying out the provisions of subchapter III of this chapter, 50 per centum of its paid-in and unimpaired capital and surplus: *Provided,* That any Federal credit union may discount with or sell to any Federal intermediate credit bank any eligible obligations up to the amount of its paid-in and unimpaired capital;

(10) to levy late charges, in accordance with the bylaws, for failure of members to meet promptly their obligations to the Federal credit union;

(11) to impress and enforce a lien upon the shares and dividends of any member, to the extent of any loan made to him and any dues or charges payable by him;

(12) in accordance with rules and regulations prescribed by the Board, to sell to members negotiable checks (including trav-

elers checks) and money orders, and to cash checks and money orders for members, for a fee which does not exceed the direct and indirect costs incident to providing such service;

(13) in accordance with rules and regulations prescribed by the Board, to purchase, sell, pledge, or discount or otherwise receive or dispose of, in whole or in part, any eligible obligations (as defined by the Board) of its members and to purchase from any liquidating credit union notes made by individual members of the liquidating credit union at such prices as may be agreed upon by the board of directors of the liquidating credit union and the board of directors of the purchasing credit union, but no purchase may be made under authority of this paragraph if, upon the making of that purchase, the aggregate of the unpaid balances of notes purchased under authority of this paragraph would exceed 5 per centum of the unimpaired capital and surplus of the credit union; and

(14) to sell all or a part of its assets to another credit union, to purchase all or part of the assets of another credit union and to assume the liabilities of the selling credit union and those of its members subject to regulations of the Board;

(15) to exercise such incidental powers as shall be necessary or requisite to enable it to carry on effectively the business for which it is incorporated.

June 26, 1934, c. 750, Title I, § 107, formerly § 7, 48 Stat. 1218; Dec. 6, 1937, c. 3, § 2, 51 Stat. 4; July 31, 1946, c. 711, § 1, 60 Stat. 744; 1947 Reorg.Plan No. 1, § 401, eff. July 1, 1947, 12 F.R. 4534, 61 Stat. 952; June 29, 1948, c. 711, §§ 1, 2, 62 Stat. 1091; Oct. 25, 1949, c. 713, § 1, 63 Stat. 890; May 13, 1952, c. 264, 66 Stat. 70, renumbered § 8 and amended Sept. 22, 1959, Pub.L. 86-354, § 1, 73 Stat. 630; July 2, 1964, Pub.L. 88-353, § 1, 78 Stat. 269; May 24, 1966, Pub.L. 89-429, § 7, 80 Stat. 167; July 3, 1967, Pub.L. 90-44, §§ 2, 3, 81 Stat. 110, 111; July 5, 1968, Pub.L. 90-375, § 1(1), (2), (3), 82 Stat. 284; Aug. 1, 1968, Pub.L. 90-448, Title VIII, § 807(n), 82 Stat. 545; Mar. 10, 1970, Pub.L. 91-206, § 2(1), 84 Stat. 49, renumbered Title I, § 107 and amended Oct. 19, 1970, Pub.L. 91-468, §§ 1(2), 10, 84 Stat. 994, 1017; June 23, 1972, Pub.L. 92-318, Title I, § 133(c)(4), 86 Stat. 270; Aug. 22, 1974, Pub.L. 93-383, Title VII, § 721, Title VIII, § 805(c)(5), 88 Stat. 719, 727; Oct. 28, 1974, Pub.L. 93-495, Title I, § 101(d), 88 Stat. 1502; Dec. 31, 1974, Pub.L. 93-569, § 6, 88 Stat. 1866; Apr. 19, 1977, Pub.L. 95-22, Title III, §§ 302, 303, 91 Stat. 49, 51; Nov. 10, 1978, Pub.L. 95-630, Title V, § 502(b), Title XVIII, § 1803, 92 Stat. 3681, 3723; Dec. 21, 1979, Pub.L. 96-153, Title III, § 323(d), 93 Stat. 1120; Dec. 28, 1979, Pub.L. 96-161, Title I, § 103(b), 93 Stat. 1234; Mar. 31, 1980, Pub.L. 96-221, Title III, §§ 305(b), 307, 309(a)(1), 310, 94 Stat. 146-149.

(x) loans must be approved by the credit committee or a loan officer, but no loan may be made to any member if, upon the making of that loan, the member would be indebted to the Federal credit union upon loans made to him in an aggregate amount which would exceed 10 per centum of the credit union's unimpaired capital and surplus.

[See main volume for text of (B) to (E), (6)]

(7) to invest its funds (A) in loans exclusively to members; (B) in obligations of the United States of America, or securities fully guaranteed as to principal and interest thereby; (C) in accordance with rules and regulations prescribed by the Board, in loans to other credit unions in the total amount not exceeding 25 per centum of its paid-in and unimpaired capital and surplus; (D) in shares or accounts of savings and loan associations or mutual savings banks, the accounts of which are insured by the Federal Savings and Loan Insurance Corporation or the Federal Deposit Insurance Corporation; (E) in obligations issued by banks for cooperatives, Federal land banks, Federal intermediate credit banks, Federal home loan banks, the Federal Home Loan Bank Board, or any corporation designated in section 846 of Title 31 as a wholly owned Government corporation; or in obligations, participations, or other instruments of or issued by, or fully guaranteed as to principal and interest by, the Federal National Mortgage Association or the Government National Mortgage Association; or in mortgages, obligations, or other securities which are or ever have been sold by the Federal Home Loan Mortgage Corporation pursuant to section 1454 or 1455 of this title; or in obligations or other instruments or securities of the Student Loan Marketing Association; or in obligations, participations, securities, or other instruments of, or issued by, or fully guaranteed as to principal and interest by any other agency of the United States and a Federal credit union may issue and sell securities which are guaranteed pursuant to section 1721(g) of this title (F) in participation certificates evidencing beneficial interests in obligations, or in the right to receive interest and principal collections therefrom, which obligations have been subjected by one or more Government agencies to a trust or trusts for which any executive department, agency, or instrumentality of the United States (or the head thereof) has been named to act as trustee; (G) in shares or deposits of any central credit union in which such investments are specifically authorized by the board of directors of the Federal credit union making the investment; (H) in shares, share certificates, or share deposits of federally insured credit unions; (I) in the shares, stocks, or obligations of any other organization, providing services which are associated with the routine operations of credit unions, up to 1 per centum of the total paid in and unimpaired capital and surplus of the credit union with the approval of the Board: *Provided, however,* That such authority does not include the power to acquire control directly or indirectly, of another financial institution, nor invest in shares, stocks or obligations of an insurance company, trade association, liquidity facility or any other similar organization, corporation, or association, except as otherwise expressly provided by this chapter; (J) in the capital stock of the National Credit Union Central Liquidity Facility; (K) investments in obligations of, or issued by, any State or political subdivision thereof (including any agency, corporation, or instrumentality of a State or political subdivision), except that no credit union may invest more than 10 per centum of its unimpaired capital and surplus in the obligations of any one issuer (exclusive of general obligations of the issuer).

(8) to make deposits in national banks and in State banks, trust companies, and mutual savings banks operating in accordance with

§ 77b. Definitions

When used in this subchapter, unless the context otherwise requires—

(1) The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

[*See main volume for text of (2) to (15)*]

As amended Oct. 13, 1982, Pub.L. 97–303, § 1, 96 Stat. 1409.

1982 Amendment. Par. (1). Pub.L. 97-303 inserted "any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency," following "mineral rights,".

Legislative History. For legislative history and purpose of Pub.L. 97–303, see 1982 U.S.Code Cong. and Adm.News, p. 2780.

Supplementary Index to Notes

3. Construction with other laws

Although there is some difference in language, definition of a "security" is virtually identical under both this subchapter and Securities Exchange Act, section 78a et seq., of this title, and omission of phrase "evidence of indebtedness" from section 78c of this title is without controlling significance. Baurer v. Planning Group, Inc., 1981, 669 F.2d 770, 215 U.S.App.D.C. 384.

4. Law governing

First Multifund for Daily Income, Inc. v. U. S., 602 F.2d 332 [main volume] 221 Ct.Cl. 123.

6. Issuers—Generally

The "controlling person" definition ascribed to the term "issuer" by this section does not apply to the private offering exemption from registration requirements of this chapter. McDaniel v. Compania Minera Mar de Cortes, Sociedad Anonimo, Inc., D.C.Ariz.1981, 528 F.Supp. 152.

13. —— Disposition for value

Dissemination of stock of one corporation among shareholders of a second corporation as a dividend following convey-

45 U.S.C.A.
1982 P.P.

1

§ 77b. Definitions

When used in this subchapter, unless the context otherwise requires—

(1) The term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general,

16

any interest or instrument commonly known as a "security", or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

(2) The term "person" means an individual, a corporation, a partnership, an association, a joint-stock company, a trust, any unincorporated organization, or a government or political subdivision thereof. As used in this paragraph the term "trust" shall include only a trust where the interest or interests of the beneficiary or beneficiaries are evidenced by a security.

(3) The term "sale" or "sell" shall include every contract of sale or disposition of a security or interest in a security, for value. The term "offer to sell", "offer for sale", or "offer" shall include every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value. The terms defined in this paragraph and the term "offer to buy" as used in subsection (c) of section 77e of this title shall not include preliminary negotiations or agreements between an issuer (or any person directly or indirectly controlling or controlled by an issuer, or under direct or indirect common control with an issuer) and any underwriter or among underwriters who are or are to be in privity of contract with an issuer (or any person directly or indirectly controlling or controlled by an issuer, or under direct or indirect common control with an issuer). Any security given or delivered with, or as a bonus on account of, any purchase of securities or any other thing, shall be conclusively presumed to constitute a part of the subject of such purchase and to have been offered and sold for value. The issue or transfer of a right or privilege, when originally issued or transferred with a security, giving the holder of such security the right to convert such security into another security of the same issuer or of another person, or giving a right to subscribe to another security of the same issuer or of another person, which right cannot be exercised until some future date, shall not be deemed to be an offer or sale of such other security; but the issue or transfer of such other security upon the exercise of such right of conversion or subscription shall be deemed a sale of such other security.

(4) The term "issuer" means every person who issues or proposes to issue any security; except that with respect to certificates of deposit, voting-trust certificates, or collateral-trust certificates, or with respect to certificates of interest or shares in an unincorporated investment trust not having a board of directors (or persons performing similar functions) or of the fixed, restricted management, or unit type, the term "issuer" means the person or persons performing the acts and assuming the duties of depositor or manager pursuant to the provisions of the

trust or other agreement or instrument under which such securities are issued; except that in the case of an unincorporated association which provides by its articles for limited liability of any or all of its members, or in the case of a trust, committee, or other legal entity, the trustees or members thereof shall not be individually liable as issuers of any security issued by the association, trust, committee, or other legal entity; except that with respect to equipment-trust certificates or like securities, the term "issuer" means the person by whom the equipment or property is or is to be used; and except that with respect to fractional undivided interests in oil, gas, or other mineral rights, the term "issuer" means the owner of any such right or of any interest in such right (whether whole or fractional) who creates fractional interests therein for the purpose of public offering.

(5) The term "Commission" means the Securities and Exchange Commission.

(6) The term "Territory" means Puerto Rico, Canal Zone, the Virgin Islands, and the insular possessions of the United States.

(7) The term "interstate commerce" means trade or commerce in securities or any transportation or communication relating thereto among the several States or between the District of Columbia or any Territory of the United States and any State or other Territory, or between any foreign country and any State, Territory, or the District of Columbia, or within the District of Columbia.

(8) The term "registration statement" means the statement provided for in section 77f of this title, and includes any amendment thereto and any report, document, or memorandum filed as part of such statement or incorporated therein by reference.

(9) The term "write" or "written" shall include printed, lithographed, or any means of graphic communication.

(10) The term "prospectus" means any prospectus, notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security; except that (a) a communication sent or given after the effective date of the registration statement (other than a prospectus permitted under subsection (b) of section 77j of this title) shall not be deemed a prospectus if it is proved that prior to or at the same time with such communication a written prospectus meeting the requirements of subsection (a) of section 77j of this title at the time of [1] such communication was sent or given to the person to whom the communication was made, and (b) a notice, circular, advertise-

ment, letter, or communication in respect of a security shall not be deemed to be a prospectus if it states from whom a written prospectus meeting the requirements of section 77j of this title may be obtained and, in addition, does no more than identify the security, state the price thereof, state by whom orders will be executed, and contain such other information as the Commission, by rules or regulations deemed necessary or appropriate in the public interest and for the protection of investors, and subject to such terms and conditions as may be prescribed therein, may permit.

(11) The term "underwriter" means any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking; but such term shall not include a person whose interest is limited to a commission from an underwriter or dealer not in excess of the usual and customary distributors' or sellers' commission. As used in this paragraph the term "issuer" shall include, in addition to an issuer, any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer.

(12) The term "dealer" means any person who engages either for all or part of his time, directly or indirectly, as agent, broker, or principal, in the business of offering, buying, selling, or otherwise dealing or trading in securities issued by another person.

(13) The term "insurance company" means a company which is organized as an insurance company, whose primary and predominant business activity is the writing of insurance or the reinsuring of risks underwritten by insurance companies, and which is subject to supervision by the insurance commissioner, or a similar official or agency, of a State or territory or the District of Columbia; or any receiver or similar official or any liquidating agent for such company, in his capacity as such.

(14) The term "separate account" means an account established and maintained by an insurance company pursuant to the laws of any State or territory of the United States, the District of Columbia, or of Canada or any province thereof, under which income, gains and losses, whether or not realized, from assets allocated to such account, are, in accordance with the applicable contract, credited to or charged against such account without regard to other income, gains, or losses of the insurance company.

(15) The term "accredited investor" shall mean—

(i) a bank as defined in section 77c(a)(2) of this title whether acting in its individual or fiduciary capacity; an insurance company as defined in paragraph (13); an investment company registered under the Investment Company Act of 1940 or a business development company as defined in section 2(a)(48) of that Act; a Small Business Investment Company licensed by the Small Business Administration; or an employee benefit plan, including an individual retirement account, which is subject to the provisions of the Employee Retirement Income Security Act of 1974, if the investment decision is made by a plan fiduciary, as defined in section 3(21) of such Act, which is either a bank, insurance company, or registered investment adviser; or

(ii) any person who, on the basis of such factors as financial sophistication, net worth, knowledge, and experience in financial matters, or amount of assets under management qualifies as an accredited investor under rules and regulations which the Commission shall prescribe.

May 27, 1933, c. 38, Title I, § 2, 48 Stat. 74; June 6, 1934, c. 404, §§ 201, 210, 48 Stat. 905, 908; Aug. 10, 1954, c. 667, Title I, §§ 1–4, 68 Stat. 683; June 25, 1959, Pub.L. 86–70, § 12(a), 73 Stat. 143; July 12, 1960, Pub.L. 86–624, § 7(a), 74 Stat. 412; Dec. 14, 1970, Pub.L. 91–547, § 27(a), 84 Stat. 1433; Oct. 21, 1980, Pub.L. 96–477, Title VI, § 603, 94 Stat. 2294.

[1] So in original. Probably should be omitted.

Historical Note

References in Text. The Investment Company Act of 1940, referred to in par. (15)(i), is Title I of Act Aug. 22, 1940, c. 686, 54 Stat. 789, which is classified generally to subchapter I (section 80a–1 et seq.) of chapter 2D of this title. Section 2(a)(48) of such Act is classified to section 80a–2(a)(48) of this title. For complete classification of this Act to the Code, see section 80a–51 of this title and Tables volume.

The Employee Retirement Income Security Act of 1974, referred to in par. (15)(i), is Pub.L. 93–406, Sept. 2, 1974, 88 Stat. 832. Section 3(21) of such Act, referred to in par. (15)(i), is classified to section 1002(21) of Title 29, Labor. For complete classification of this Act to the Code, see Short Title note set out under section 1001 Title 29 and Tables volume.

Codification. Words "Philippine Islands" were deleted from the definition of term "Territory" under authority of Proc.No.2695, eff. July 4, 1946, 11 F.R. 7517, 60 Stat. 1352, which granted independence to the Philippine Islands. Proc.No.2695 was issued pursuant to section 1394 of Title 22, Foreign Relations and Intercourse, and is set out as a note under that section.

1980 Amendment. Par. (15). Pub.L. 96–477 added par. (15).

1970 Amendment. Pars. (13), (14). Pub.L. 91–547 added pars. (13) and (14).

1960 Amendment. Par. (6). Pub.L. 86–624 eliminated Hawaii from par. (6).

1959 Amendment. Par. (6). Pub.L. 86–70 eliminated Alaska from par. (6).

1954 Amendment. Act Aug. 10, 1954, in pars. (3), (8), (10), and (11), redefined the term "sale" so as to distinguish between "offers" and "sales", clarified the definition of "registration statement", and conformed the definition of "prospectus" to changes made by Act Aug. 10, 1954, to sections 77e and 77j of this title.

1934 Amendment. Act June 6, 1934, § 201, amended pars. (1), (4), and (10).

Effective Date of 1970 Amendment. Pars. (13) and (14) effective Dec. 14, 1970, see section 30 of Pub.L. 91–547, set out as

40. Record

On vacation of prior judgment in securities case and remand for reconsideration, pursuant to United States Supreme Court mandate, of standard of materiality of omissions or misrepresentations making the private placement exemption from registration requirements unavailable district court could decide the matter on the original record or, in its discretion, conduct a hearing on the materiality of the alleged misrepresentations and omissions. Woolf v. S. D. Cohn & Co., C.A.Fla.1977, 546 F.2d 1252, certiorari denied 98 S.Ct. 115, 434 U.S. 831, 54 L.Ed. 2d 91.

41. Remand

It was error to deny as matter of law preliminary injunctive relief against activities of underwriter participating in scheme for distribution of unregistered common stock of worthless corporation in violation of this subchapter and order would be vacated and case remanded so that trial court could exercise its equitable discretion in deciding whether to include or exclude underwriter. Securities and Exchange Commission v. North Am. Research & Development Corp., C.A.N.Y. 1970, 424 F.2d 63.

§ 77e. Prohibitions relating to interstate commerce and the mails

Sale or delivery after sale of unregistered securities

(a) Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly—

(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise; or

(2) to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale.

Necessity of prospectus meeting requirements of section 77j of this title

(b) It shall be unlawful for any person, directly or indirectly—

(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to carry or transmit any prospectus relating to any security with respect to which a registration statement has been filed under this subchapter, unless such prospectus meets the requirements of section 77j of this title; or

(2) to carry or cause to be carried through the mails or in interstate commerce any such security for the purpose of sale or for delivery after sale, unless accompanied or preceded by a prospectus that meets the requirements of subsection (a) of section 77j of this title.

Necessity of filing registration statement

(c) It shall be unlawful for any person, directly or indirectly, to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell or offer

to buy through the use or medium of any prospectus or otherwise any security, unless a registration statement has been filed as to such security, or while the registration statement is the subject of a refusal order or stop order or (prior to the effective date of the registration statement) any public proceeding or examination under section 77h of this title.

May 27, 1933, c. 38, Title I, § 5, 48 Stat. 77; June 6, 1934, c. 404, Title II, § 204, 48 Stat. 906; Aug. 10, 1954, c. 667, Title I, § 7, 68 Stat. 684.

Historical Note

1954 Amendment. Subsec. (a)(1). Act Aug. 10, 1954 deleted "or offer to buy" following "to sell".

Subsec. (b). Act Aug. 10, 1954, in par. (1), substituted "with respect to which a registration statement has been filed" for "registered" and in par. (2) omitted "to" following "to carry or" and added "subsection (a) of" preceding "section 77j of this title".

Subsec. (c). Act Aug. 10, 1954 added subsec. (c).

1934 Amendment. Subsec. (c). Act June 6, 1934 repealed former subsec. (c), the provisions of which are now covered by section 77c(a)(11) of this title.

Effective Date of 1954 Amendment. Amendment effective 60 days after Aug. 10, 1954, see section 501 of Act Aug. 10, 1954, set out as an Effective Date of 1954 Amendment note under section 77b of this title.

Legislative History. For legislative history and purpose of Act Aug. 10, 1954, see 1954 U.S.Code Cong. and Adm.News, p. 2973.

Cross References

Certificates of deposit issued in proceedings for modification of railroad financial structures, exemption, see section 11367 of Title 49, Transportation.
Civil liabilities for selling securities in violation of this section, see section 77l of this title.
Inapplicability of section to certain offers or sales in reorganization proceedings, see section 1145 of Title 11, Bankruptcy.
Intrastate issue of securities as exempt from this subchapter, see section 77c of this title.
Offer to buy, defined, see section 77b of this title.
Prospectus omitting or summarizing information, see section 77j of this title.
Taking effect of registration statements and amendments thereto, see section 77h of this title.
Transactions exempted from this section, see section 77d of this title.
Trust Indenture Act of 1939, exempted securities and transactions, see section 77ddd of this title.

Library References

Securities Regulation ⟹25. C.J.S. Securities Regulation §§ 8, 10.

Code of Federal Regulations

General regulatory policies,
Securities Act of 1933, see 17 CFR 230.100 et seq.
Securities Exchange Act of 1934, see 17 CFR 240.0-1 et seq.

Notes of Decisions

I. GENERALLY 1-70
II. PRACTICE AND PROCEDURE 71-137

Generally 1-70
Acquittal 126
Admissibility of evidence
Generally 108
Harmless or prejudicial error 123

from stock purchases made in reliance upon a false and misleading registration statement, motion to require stockholders to post $50,000 security for costs would be denied where defendants did not sufficiently establish that they could not have foreseen downturn in corporation's business which formed the basis for the action and thus were unable to show that plaintiff's complaint was obviously without merit. Id.

Two basic elements of this section relating to posting of undertaking to cover costs of suit under this subchapter are that matter is within proper discretion of the court and that for motion to succeed defendant must demonstrate that suit is without merit. General Inv. Co. of Conn. v. Ackerman, D.C.N.Y.1964, 37 F.R.D. 38.

Defendants, sued by investment companies under this section for alleged misrepresentations which induced purchase of securities, failed to show suit was of a frivolous nature and their motion to require posting of bond to cover costs of suit, including reasonable attorneys' fees, was denied. Id.

Where affidavits of plaintiff stockholders in action against corporation under this subchapter based on alleged misstatements or omission in registration statement in connection with issuance of convertible preferred stock did not dispel notion that plaintiffs knew of alleged misleading statements before time alleged in complaint, plaintiffs would be required to file security. Fischman v. Raytheon Mfg. Co., D.C.N.Y.1949, 9 F.R.D. 707.

85. Findings

An award of attorney's fees against plaintiff whose action against a broker based on violations of the federal securities law was dismissed with prejudice could not be upheld in absence of findings of fact and conclusions of law with respect to frivolity of the complaint. Klein v. Shields & Co., C.A.N.Y.1972, 470 F.2d 1344.

In view of district court's failure to set down its findings of fact and conclusions of law and to specifically make a finding as to whether suit against defendants for alleged violations of this subchapter, relative to registration and misstatement or omission of material fact was without merit, court of appeals could not determine whether district court's award of an attorney's fee to one of the defendants after a voluntary dismissal of suit was proper. Oil & Gas Income, Inc. v. Woods Exploration & Producing Co., C.A.La. 1966, 362 F.2d 309.

86. Issues reviewable

Orders denying applications for security are appealable when court considered itself without power to give requested relief. Donlon Industries, Inc. v. Forte, C.A.N.Y.1968, 402 F.2d 935.

Orders granting applications for security are appealable when appeal challenges court's power. Id.

Stockholders appealing from order dismissing complaint for losses arising out of alleged untruthful statements in and fraudulent conduct in use of prospectus or registration statement could challenge validity of requirement of bond as condition of repleading, since failure to comply with condition led to the final order of dismissal. Fischman v. Raytheon Mfg. Co., C.A.N.Y.1951, 188 F.2d 783.

Where complaint containing two counts set forth only one claim for relief, based in part on the common law and in part on this section and section 77o of this title, neither an order granting motion to dismiss one count nor judgment dismissing such count leaving the other pending would be an appealable "final decision" of the district court. Wright v. Gibson, C.C.A.Cal.1942, 128 F.2d 865.

87. Reversal

In view of erroneous determinations of class action issues as well as fraud issue, reviewing court was constrained to reverse trial court's orders dismissing actions with prejudice after plaintiffs had refused to accept settlements proffered by defendants. Williams v. Sinclair, C.A.Or.1975, 529 F.2d 1383, certiorari denied 96 S.Ct. 2651, 426 U.S. 936, 49 L.Ed.2d 388.

§ 77l. Civil liabilities arising in connection with prospectuses and communications

Any person who—

(1) offers or sells a security in violation of section 77e of this title, or

(2) offers or sells a security (whether or not exempted by the provisions of section 77c of this title, other than paragraph

(2) of subsection (a) of said section), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission,

shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

May 27, 1933, c. 38, Title I, § 12, 48 Stat. 84; Aug. 10, 1954, c. 667, Title I, § 9, 68 Stat. 686.

Historical Note

1954 Amendment. Act Aug. 10, 1954 inserted in pars. (1) and (2) "offers or" preceding "sells".

Effective Date of 1954 Amendment. Amendment effective 60 days after Aug. 10, 1954, see section 501 of Act Aug. 10, 1954, set out as an Effective Date of 1954 Amendment note under section 77b of this title.

Legislative History. For legislative history and purpose of Act Aug. 10, 1954, see 1954 U.S.Code Cong. and Adm.News, p. 2973.

Cross References

Information and documents to determine eligibility of indenture trustee and analysis of indenture, section as inapplicable to, see section 77eee of this title.
Liability of controlling persons under this section, see section 77o of this title.
Limitation of actions, see section 77m of this title.

Federal Rules of Civil Procedure

One form of action, see rule 2, Title 28, Judiciary and Judicial Procedure

Library References

Securities Regulation ⟾103, 149, 154. C.J.S. Securities Regulation §§ 94, 98, 152, 153, 157.

Notes of Decisions

§ 77p. Additional remedies

The rights and remedies provided by this subchapter shall be in addition to any and all other rights and remedies that may exist at law or in equity.

May 27, 1933, c. 38, Title I, § 16, 48 Stat. 84.

Cross References

Securities Exchange Act of 1934 as providing additional remedies, see section 78bb of this title.

Library References

Securities Regulation ⟹131.

C.J.S. Securities Regulation §§ 128, 129, 133.

Notes of Decisions

1. Construction with other laws

Section 1 this title, which is addressed more generally to contracts, combinations and conspiracies "in restraint of trade or commerce," was not applicable to suit alleging a market rigging scheme in relation to a certain stock, since there were special statutory provisions in the securities laws affording relief from alleged misconduct of defendants, and fact that this section and section 78bb of this title contained clauses preserving "rights and remedies that may exist at law or in equity" did not warrant a different result since, section 78bb of this title expressly limited recovery thereunder to actual damages, while this section had been similarly construed. Schaefer v. First Nat. Bank of Lincolnwood, D.C.Ill.1970, 326 F.Supp. 1186, appeal dismissed 465 F.2d 234.

2. State regulation or control

This section does not relate to venue or enlarge the remedy given by section 77l of this title, but Congress sought only to make it clear that it was not preempting the field to the federal jurisdiction, thereby prohibiting recovery to a defrauded person under the law of the states as it existed before passage of this subchapter. Independence Shares Corporation v. Deckert, C.C.A.Pa.1939, 108 F.2d 51, reversed on other grounds 61 S.Ct. 229, 311 U.S. 282, 85 L.Ed. 189.

3. Damages

In view of this savings clause, prayer for punitive damages in case brought under this subchapter was to be viewed in light of local law. Nagel v. Prescott & Co., D.C.Ohio 1964, 36 F.R.D. 445.

§ 77q. Fraudulent interstate transactions

Use of interstate commerce for purpose of fraud or deceit

(a) It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser.

Use of interstate commerce for purpose of offering for sale

(b) It shall be unlawful for any person, by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, to publish, give publicity to, or circulate any notice, circular, advertisement, newspaper, article, letter, investment service, or communication which, though not purporting to offer a security for sale, describes such security for a consideration received or to be received, directly or indirectly, from an issuer, underwriter, or dealer, without fully disclosing the receipt, whether past or prospective, of such consideration and the amount thereof.

Exemption of section 77c not applicable to this section

(c) The exemptions provided in section 77c of this title shall not apply to the provisions of this section.

May 27, 1933, c. 38, Title I, § 17, 48 Stat. 84; Aug. 10, 1954, c. 667, Title I, § 10, 68 Stat. 686.

Historical Note

1954 Amendment. Subsec. (a). Act Aug. 10, 1954 inserted in the introductory paragraph "offer or" preceding "sale".

Effective Date of 1954 Amendment. Amendment effective 60 days after Aug. 10, 1954, see section 501 of Act Aug. 10, 1954, set out as an Effective Date of 1954 Amendment note under section 77b of this title.

Cross References

Fraud and false statements, see section 1001 et seq. of Title 18, Crimes and Criminal Procedure.

Information and documents to determine eligibility of indenture trustee and analysis of indenture, section as inapplicable to, see section 77eee of this title.

Library References

Securities Regulation ⚷102 et seq., 192.

C.J.S. Securities Regulation §§ 96, 97, 172, 176.

Notes of Decisions

Historical Note

Transfer of Functions. For transfer of the functions of the Securities and Exchange Commission, with certain exceptions, to the chairman of such commission, see Reorg. Plan No. 10 of 1950, §§ 1, 2, eff. May 24, 1950, 15 F.R. 3175, 64 Stat. 1265, set out under section 78d of this title.

Cross References

Hearings by Commission under—
- Investment Advisers Act of 1940, see section 80b–12 of this title.
- Investment Company Act of 1940, see section 80a–40 of this title.
- Public Utility Holding Company Act of 1935, see section 79s of this title.
- Securities Exchange Act of 1934, see section 78v of this title.
- Trust Indenture Act of 1939, see section 77ttt of this title.

Library References

Securities Regulation ⟹64 et seq.

C.J.S. Securities Regulation §§ 87 to 92.

Rules of Practice for Securities and Exchange Commission

For Rules of Practice for Securities and Exchange Commission, see part 201 of Title 17, Code of Federal Regulations, set out following section 78u of this title.

Code of Federal Regulations

Information, requests, etc., see 17 CFR 200.80 et seq.

Notes of Decisions

Names of witnesses 3
Persons conducting hearings 1
Private investigations 4
Qualifications of hearing officers 2

1. Persons conducting hearings

Attorney for Commission is not disqualified to conduct hearing. Securities and Exchange Commission v. Jones, D.C. N.Y.1935, 12 F.Supp. 210, affirmed 79 F.2d 617, reversed on other grounds 56 S.Ct. 654, 298 U.S. 1, 80 L.Ed. 1015.

2. Qualifications of hearing officers

Underwriter could not enjoin proceeding pending before Commission relating to issuance and sale of stock, by claiming alleged disqualification of member of Commission because of prior staff service, and underwriter had to first exhaust its administrative remedies. Securities and Exchange Commission v. R. A. Holman & Co., 1963, 323 F.2d 284, 116 U.S. App.D.C. 279, certiorari denied 84 S.Ct. 350, 375 U.S. 943, 11 L.Ed.2d 274.

3. Names of witnesses

Commission is not required to furnish a list of all prospective witnesses' names prior to a hearing. Armstrong, Jones & Co. v. Securities and Exchange Commission, C.A.Mich.1970, 421 F.2d 359, certiorari denied 90 S.Ct. 2172, 398 U.S. 958, 26 L.Ed.2d 543.

4. Private investigations

The Commission's rule, allowing private investigations is reasonable and authorized by this subchapter, as investigations authorized thereby are not synonymous with hearings, which this section requires to be public. Woolley v. U. S., C.C.A.Cal.1938, 97 F.2d 258, certiorari denied 59 S.Ct. 73, 305 U.S. 614, 83 L.Ed. 391.

§ 77v. Jurisdiction of offenses and suits

(a) The district courts of the United States, and the United States courts of any Territory, shall have jurisdiction of offenses and violations under this subchapter and under the rules and regulations promulgated by the Commission in respect thereto, and, con-

current with State and Territorial courts, of all suits in equity and actions at law brought to enforce any liability or duty created by this subchapter. Any such suit or action may be brought in the district wherein the defendant is found or is an inhabitant or transacts business, or in the district where the offer or sale took place, if the defendant participated therein, and process in such cases may be served in any other district of which the defendant is an inhabitant or wherever the defendant may be found. Judgments and decrees so rendered shall be subject to review as provided in sections 1254, 1291, and 1292 of Title 28. No case arising under this subchapter and brought in any State court of competent jurisdiction shall be removed to any court of the United States. No costs shall be assessed for or against the Commission in any proceeding under this subchapter brought by or against it in the Supreme Court or such other courts.

(b) In case of contumacy or refusal to obey a subpena issued to any person, any of the said United States courts, within the jurisdiction of which said person guilty of contumacy or refusal to obey is found or resides, upon application by the Commission may issue to such person an order requiring such person to appear before the Commission, or one of its examiners designated by it, there to produce documentary evidence if so ordered, or there to give evidence touching the matter in question; and any failure to obey such order of the court may be punished by said court as a contempt thereof.

May 27, 1933, c. 38, Title I, § 22, 48 Stat. 86; June 25, 1936, c. 804, 49 Stat. 1921; June 25, 1948, c. 646, § 32(b), 62 Stat. 991; May 24, 1949, c. 139, § 127, 63 Stat. 107; Aug. 10, 1954, c. 667, Title I, § 11, 68 Stat. 686; Oct. 15, 1970, Pub.L. 91–452, Title II, § 213, 84 Stat. 929.

Historical Note

Codification. As originally enacted subsec. (a) contained references to the Supreme Court of the District of Columbia. Act June 25, 1936, substituted "the district court of the United States for the District of Columbia" for "the Supreme Court of the District of Columbia", and Act June 25, 1948, as amended by Act May 24, 1949, substituted "United States District Court for the District of Columbia" for "district court of the United States for the District of Columbia". However, the words "United States District Court for the District of Columbia" have now been deleted entirely as superfluous in view of section 132(a) of Title 28 Judiciary and Judicial Procedure, which states that "There shall be in each judicial district a district court which shall be a court of record known as the United States District Court for the district", and section 88 of Title 28 which states that "the District of Columbia constitutes one judicial district".

Reference to "sections 1254, 1291, and 1292 of Title 28" was substituted for "sections 128 and 240 of the Judicial Code, as amended (U.S.C., title 28, secs. 225 and 347)" on authority of Act June 25, 1948, c. 646, 62 Stat. 869, the first section of which enacted Title 28.

1970 Amendment. Subsec. (c). Pub.L. 91–452 struck out subsec. (c) which related to the immunity from prosecution of any individual compelled to testify or produce evidence, documentary or otherwise, after claiming his privilege against self-incrimination.

1954 Amendment. Subsec. (a). Act Aug. 10, 1954 inserted in the second sentence "offer or" preceding "sale".

Effective Date of 1970 Amendment. Amendment by Pub.L. 91–452 effective the sixtieth day following Oct. 15, 1970, see section 260 of Pub.L. 91–452, set out as an Effective Date; Savings Provision

CHAPTER 2B—SECURITIES EXCHANGES

Cross References

Financial institution defined to include broker or dealer registered under this chapter for purposes of provisions relating to records and reports on monetary instruments transactions, see section 5312 of Title 31, Money and Finance.

§ 78a. Short title

Federal Practice and Procedure

Adequacy of representation of members in class actions under this chapter, see Wright & Miller: Civil § 1765.

Change of venue in interest of justice, see Wright, Miller & Cooper: Jurisdiction § 3854.

Conflicting interests between representatives and members in class actions under this chapter, see Wright & Miller: Civil § 1768.

Consolidation of actions brought under this chapter, see Wright & Miller: Civil § 2383.

Discovery of relevant subject matter, see Wright & Miller: Civil § 2009.

Joinder of claims, see Wright & Miller: Civil § 1587.

Permissive joinder of plaintiffs in actions under this chapter, see Wright & Miller: Civil § 1658.

Service of process on foreign government or one of its agencies in state in which it it doing business, see Wright & Miller: Civil § 1111.

Venue in actions to enforce liability or duty under this section, see Wright, Miller & Cooper: Jurisdiction § 3824.

§ 78b. Necessity for regulation

4. Purpose—Generally

This chapter was designed to provide for regulation of securities exchanges and of over-the-counter markets to prevent inequitable and unfair practices in such exchanges and markets. In re New York City Municipal Securities Litigation, D.C.N.Y.1980, 507 F.Supp. 169.

§ 78c. Definitions and application

Definitions

(a) When used in this chapter, unless the context otherwise requires—

[See main volume for text of (1) to (9)]

(10) The term "security" means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

[See main volume for text of (11) to (40); (b) to (d)]

As amended Oct. 13, 1982, Pub.L. 97–303, § 2, 96 Stat. 1409.

1982 Amendment. Subsec. (a)(10). Pub.L. 97-303 added "any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency," following "for a security,".

Legislative History. For legislative history and purpose of Pub.L. 97-303, see 1982 U.S.Code Cong. and Adm.News, p. 2781.

Supplementary Index to Notes

3. Law governing

This section preempted specific provisions of the Missouri Takeover Bid Disclosure Act section 409.500 et seq. RSMo 1959, V.A.M.S. relating to time tables, disclosure requirements, and substantive requirements. National City Lines, Inc. v. LLC Corp., C.A.Mo.1982, 687 F.2d 1122.

6. Buy and purchase

For purpose of this chapter and the Securities Act of 1933, section 77a et seq. of this title, plaintiff was a "purchaser" of investment note which he received from defendant in exchange for sums advanced in anticipation of securing a limited partnership interest notwithstanding that he never joined the limited partnership agreement since the note was itself a security and the exchange of funds therefore constituted a "purchase."

§ 78c. Definitions and application

Definitions

(a) When used in this chapter, unless the context otherwise requires—

(1) The term "exchange" means any organization, association, or group of persons, whether incorporated or unincorporated, which constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange as that term is generally understood, and includes the market place and the market facilities maintained by such exchange.

(2) The term "facility" when used with respect to an exchange includes its premises, tangible or intangible property whether on the premises or not, any right to the use of such premises or property or any service thereof for the purpose of effecting or reporting a transaction on an exchange (including, among other things, any system of communication to or from the exchange, by ticker or otherwise, maintained by or with the consent of the exchange), and any right of the exchange to the use of any property or service.

(3)(A) The term "member" when used with respect to a national securities exchange means (i) any natural person permitted to effect transactions on the floor of the exchange without the services of another person acting as broker, (ii) any registered broker or dealer with which such a natural person is associated, (iii) any registered broker or dealer permitted to designate as a representative such a natural person, and (iv) any other registered broker or dealer which agrees to be regulated by such exchange and with respect to which the exchange undertakes to enforce compliance with the provisions of this chapter, the rules and regulations thereunder, and its own rules. For purposes of sections 78f(b)(1), 78f(b)(4), 78f(b)(6), 78f(b)(7), 78f(d), 78q(d), 78s(d), 78s(e), 78s(g), 78s(h), and 78u of this title, the term "member" when used with respect to a national securities exchange also means, to the extent of the rules of the exchange specified by the Commission, any person required by the Commission to comply with such rules pursuant to section 78f(f) of this title.

(B) The term "member" when used with respect to a registered securities association means any broker or dealer who agrees to be regulated by such association and with respect to whom the association undertakes to enforce compliance with the provisions of this chapter, the rules and regulations thereunder, and its own rules.

(4) The term "broker" means any person engaged in the business of effecting transactions in securities for the account of others, but does not include a bank.

(5) The term "dealer" means any person engaged in the business of buying and selling securities for his own account, through a broker or otherwise, but does not include a bank, or any person insofar as he buys or sells securities for his own account, either individually or in some fiduciary capacity, but not as a part of a regular business.

(6) The term "bank" means (A) a banking institution organized under the laws of the United States, (B) a member bank of the Federal Reserve System, (C) any other banking institution, whether incorporated or not, doing business under the laws of any State or of the United States, a substantial portion of the business of which consists of receiving deposits or exercising fiduciary powers similar to those permitted to national banks under section 11(k) of the Federal Reserve Act, as amended, and which is supervised and examined by State or Federal authority having supervision over banks, and which is not operated for the purpose of evading the provisions of this chapter, and (D) a receiver, conservator, or other liquidating agent of any institution or firm included in clauses (A), (B), or (C) of this paragraph.

(7) The term "director" means any director of a corporation or any person performing similar functions with respect to any organization, whether incorporated or unincorporated.

(8) The term "issuer" means any person who issues or proposes to issue any security; except that with respect to certificates of deposit for securities, voting-trust certificates, or collateral-trust certificates, or with respect to certificates of interest or shares in an unincorporated investment trust not having a board of directors or of the fixed, restricted management, or unit type, the term "issuer" means the person or persons performing the acts and assuming the duties of depositor or manager pursuant to the provisions of the trust or other agreement or instrument under which such securities are issued; and except that with respect to equipment-trust certificates or like securities, the term "issuer" means the person by whom the equipment or property is, or is to be, used.

(9) The term "person" means a natural person, company, government, or political subdivision, agency, or instrumentality of a government.

(10) The term "security" means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of

exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

(11) The term "equity security" means any stock or similar security; or any security convertible, with or without consideration, into such a security, or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right; or any other security which the Commission shall deem to be of similar nature and consider necessary or appropriate, by such rules and regulations as it may prescribe in the public interest or for the protection of investors, to treat as an equity security.

(12) The term "exempted security" or "exempted securities" includes securities which are direct obligations of, or obligations guaranteed as to principal or interest by, the United States; such securities issued or guaranteed by corporations in which the United States has a direct or indirect interest as shall be designated for exemption by the Secretary of the Treasury as necessary or appropriate in the public interest or for the protection of investors; municipal securities, as defined in paragraph (29) of this subsection: *Provided, however,* That municipal securities shall not be deemed to be "exempted securities" for purposes of sections 78*o*, 78*o*–3 (except subsections (b)(6), (b)(11), and (g)(2) thereof), and 78q–1 of this title; any interest or participation in any common trust fund or similar fund maintained by a bank exclusively for the collective investment and reinvestment of assets contributed thereto by such bank in its capacity as trustee, executor, administrator, or guardian; any interest or participation in a single trust fund, or a collective trust fund maintained by a bank, or any security arising out of a contract issued by an insurance company, which interest, participation, or security is issued in connection with (A) a stock bonus, pension, or profit-sharing plan which meets the requirements for qualification under section 401 of Title 26, (B) an annuity plan which meets the requirements for the deduction of the employer's contribution under section 404(a)(2) of Title 26, or (C) a governmental plan as defined in section 414(d) of Title 26 which has been established by an employer for the exclusive benefit of its employees or their beneficiaries for the purpose of distributing to such employees or their beneficiaries the corpus and income of the funds accumulated under such plan, if under such plan it is impossible, prior to the satisfaction of all liabilities with respect to such employees and their beneficiaries, for any part of the corpus or income to be used for, or diverted to, purposes other than the exclusive benefit of such employees or their beneficiaries, other than any plan described in clause (A), (B), or (C) of this paragraph (i) which covers employees some or all of whom are employees within the meaning of section 401(c) of Title 26, or (ii) which is a plan funded

by an annuity contract described in section 403(b) of Title 26; and such other securities (which may include, among others, unregistered securities, the market in which is predominantly intrastate) as the Commission may, by such rules and regulations as it deems consistent with the public interest and the protection of investors, either unconditionally or upon specified terms and conditions or for stated periods, exempt from the operation of any one or more provisions of this chapter which by their terms do not apply to an "exempted security" or to "exempted securities".

(13) The terms "buy" and "purchase" each include any contract to buy, purchase, or otherwise acquire.

(14) The terms "sale" and "sell" each include any contract to sell or otherwise dispose of.

(15) The term "Commission" means the Securities and Exchange Commission established by section 78d of this title.

(16) The term "State" means any State of the United States, the District of Columbia, Puerto Rico, the Canal Zone, the Virgin Islands, or any other possession of the United States.

(17) The term "interstate commerce" means trade, commerce, transportation, or communication among the several States, or between any foreign country and any State, or between any State and any place or ship outside thereof. The term also includes intrastate use of (A) any facility of a national securities exchange or of a telephone or other interstate means of communication, or (B) any other interstate instrumentality.

(18) The term "person associated with a broker or dealer" or "associated person of a broker or dealer" means any partner, officer, director, or branch manager of such broker or dealer (or any person occupying a similar status or performing similar functions), any person directly or indirectly controlling, controlled by, or under common control with such broker or dealer, or any employee of such broker or dealer, except that any person associated with a broker or dealer whose functions are solely clerical or ministerial shall not be included in the meaning of such term for purposes of section 78*o*(b) of this title (other than paragraph (6) thereof).

(19) The terms "investment company", "affiliated person", "insurance company", "separate account", and "company" have the same meanings as in the Investment Company Act of 1940.

(20) The terms "investment adviser" and "underwriter" have the same meanings as in the Investment Advisers Act of 1940.

(21) The term "person associated with a member" or "associated person of a member" when used with respect to a member of a national securities exchange or registered securities association means any partner, officer, director, or branch manager of such member (or any person occupying a similar status or performing similar functions), any person directly or indirectly controlling, controlled

by, or under common control with such member, or any employee of such member.

(22)(A) The term "securities information processor" means any person engaged in the business of (i) collecting, processing, or preparing for distribution or publication, or assisting, participating in, or coordinating the distribution or publication of, information with respect to transactions in or quotations for any security (other than an exempted security) or (ii) distributing or publishing (whether by means of a ticker tape, a communications network, a terminal display device, or otherwise) on a current and continuing basis, information with respect to such transactions or quotations. The term "securities information processor" does not include any bona fide newspaper, news magazine, or business or financial publication of general and regular circulation, any self-regulatory organization, any bank, broker, dealer, building and loan, savings and loan, or homestead association, or cooperative bank, if such bank, broker, dealer, association, or cooperative bank would be deemed to be a securities information processor solely by reason of functions performed by such institutions as part of customary banking, brokerage, dealing, association, or cooperative bank activities, or any common carrier, as defined in section 153(h) of Title 47, subject to the jurisdiction of the Federal Communications Commission or a State commission, as defined in section 153(t) of Title 47, unless the Commission determines that such carrier is engaged in the business of collecting, processing, or preparing for distribution or publication, information with respect to transactions in or quotations for any security.

(B) The term "exclusive processor" means any securities information processor or self-regulatory organization which, directly or indirectly, engages on an exclusive basis on behalf of any national securities exchange or registered securities association [1] or any national securities exchange or registered securities association which engages on an exclusive basis on its own behalf [1] in collecting, processing, or preparing for distribution or publication any information with respect to (i) transactions or quotations on or effected or made by means of any facility of such exchange or (ii) quotations distributed or published by means of any electronic system operated or controlled by such association.

(23)(A) The term "clearing agency" means any person who acts as an intermediary in making payments or deliveries or both in connection with transactions in securities or who provides facilities for comparison of data respecting the terms of settlement of securities transactions, to reduce the number of settlements of securities transactions, or for the allocation of securities settlement responsibilities. Such term also means any person, such as a securities depository, who (i) acts as a custodian of securities in connection with a system for the central handling of securities whereby all se-

curities of a particular class or series of any issuer deposited within the system are treated as fungible and may be transferred, loaned, or pledged by bookkeeping entry without physical delivery of securities certificates, or (ii) otherwise permits or facilitates the settlement of securities transactions or the hypothecation or lending of securities without physical delivery of securities certificates.

(B) The term "clearing agency" does not include (i) any Federal Reserve bank, Federal home loan bank, or Federal land bank; (ii) any national securities exchange or registered securities association solely by reason of its providing facilities for comparison of data respecting the terms of settlement of securities transactions effected on such exchange or by means of any electronic system operated or controlled by such association; (iii) any bank, broker, dealer, building and loan, savings and loan, or homestead association, or cooperative bank if such bank, broker, dealer, association, or cooperative bank would be deemed to be a clearing agency solely by reason of functions performed by such institution as part of customary banking, brokerage, dealing, association, or cooperative banking activities, or solely by reason of acting on behalf of a clearing agency or a participant therein in connection with the furnishing by the clearing agency of services to its participants or the use of services of the clearing agency by its participants, unless the Commission, by rule, otherwise provides as necessary or appropriate to assure the prompt and accurate clearance and settlement of securities transactions or to prevent evasion of this chapter; (iv) any life insurance company, its registered separate accounts, or a subsidiary of such insurance company solely by reason of functions commonly performed by such entities in connection with variable annuity contracts or variable life policies issued by such insurance company or its separate accounts; (v) any registered open-end investment company or unit investment trust solely by reason of functions commonly performed by it in connection with shares in such registered open-end investment company or unit investment trust, or (vi) any person solely by reason of its performing functions described in paragraph (25)(E) of this subsection.

(24) The term "participant" when used with respect to a clearing agency means any person who uses a clearing agency to clear or settle securities transactions or to transfer, pledge, lend, or hypothecate securities. Such term does not include a person whose only use of a clearing agency is (A) through another person who is a participant or (B) as a pledgee of securities.

(25) The term "transfer agent" means any person who engages on behalf of an issuer of securities or on behalf of itself as an issuer of securities in (A) countersigning such securities upon issuance; (B) monitoring the issuance of such securities with a view to preventing unauthorized issuance, a function commonly performed by a person called a registrar; (C) registering the transfer of such securities;

(D) exchanging or converting such securities; or (E) transferring record ownership of securities by bookkeeping entry without physical issuance of securities certificates. The term "transfer agent" does not include any insurance company or separate account which performs such functions solely with respect to variable annuity contracts or variable life policies which it issues or any registered clearing agency which performs such functions solely with respect to options contracts which it issues.

(26) The term "self-regulatory organization" means any national securities exchange, registered securities association, or registered clearing agency, or (solely for purposes of sections 78s(b), 78s(c), and 78w(b) of this title) the Municipal Securities Rulemaking Board established by section 78o–4 of this title.

(27) The term "rules of an exchange", "rules of an association", or "rules of a clearing agency" means the constitution, articles of incorporation, bylaws, and rules, or instruments corresponding to the foregoing, of an exchange, association of brokers and dealers, or clearing agency, respectively, and such of the stated policies, practices, and interpretations of such exchange, association, or clearing agency as the Commission, by rule, may determine to be necessary or appropriate in the public interest or for the protection of investors to be deemed to be rules of such exchange, association, or clearing agency.

(28) The term "rules of a self-regulatory organization" means the rules of an exchange which is a national securities exchange, the rules of an association of brokers and dealers which is a registered securities association, the rules of a clearing agency which is a registered clearing agency, or the rules of the Municipal Securities Rulemaking Board.

(29) The term "municipal securities" means securities which are direct obligations of, or obligations guaranteed as to principal or interest by, a State or any political subdivision thereof, or any agency or instrumentality of a State or any political subdivision thereof, or any municipal corporate instrumentality of one or more States, or any security which is an industrial development bond (as defined in section 103(c)(2) of Title 26) the interest on which is excludable from gross income under section 103(a)(1) of Title 26 if, by reason of the application of paragraph (4) or (6) of section 103(c) of Title 26 (determined as if paragraphs (4)(A), (5), and (7) were not included in such section 103(c)), paragraph (1) of such section 103(c) does not apply to such security.

(30) The term "municipal securities dealer" means any person (including a separately identifiable department or division of a bank) engaged in the business of buying and selling municipal securities for his own account, through a broker or otherwise, but does not include—

(A) any person insofar as he buys or sells such securities for his own account, either individually or in some fiduciary capacity, but not as a part of a regular business; or

(B) a bank, unless the bank is engaged in the business of buying and selling municipal securities for its own account other than in a fiduciary capacity, through a broker or otherwise: *Provided, however,* That if the bank is engaged in such business through a separately identifiable department or division (as defined by the Municipal Securities Rulemaking Board in accordance with section 78o–4(b)(2)(H) of this title), the department or division and not the bank itself shall be deemed to be the municipal securities dealer.

(31) The term "municipal securities broker" means a broker engaged in the business of effecting transactions in municipal securities for the account of others.

(32) The term "person associated with a municipal securities dealer" when used with respect to a municipal securities dealer which is a bank or a division or department of a bank means any person directly engaged in the management, direction, supervision, or performance of any of the municipal securities dealer's activities with respect to municipal securities, and any person directly or indirectly controlling such activities or controlled by the municipal securities dealer in connection with such activities.

(33) The term "municipal securities investment portfolio" means all municipal securities held for investment and not for sale as part of a regular business by a municipal securities dealer or by a person, directly or indirectly, controlling, controlled by, or under common control with a municipal securities dealer.

(34) The term "appropriate regulatory agency" means—

(A) When used with respect to a municipal securities dealer:

(i) the Comptroller of the Currency, in the case of a national bank or a bank operating under the Code of Law for the District of Columbia, or a subsidiary or a department or division of any such bank;

(ii) the Board of Governors of the Federal Reserve System, in the case of a State member bank of the Federal Reserve System, a subsidiary or a department or division thereof, a bank holding company, a subsidiary of a bank holding company which is a bank other than a bank specified in clause (i) or (iii) of this subparagraph, or a subsidiary or a department or division of such subsidiary;

(iii) the Federal Deposit Insurance Corporation, in the case of a bank insured by the Federal Deposit Insurance Corporation (other than a member of the Federal Reserve System), or a subsidiary or department or division thereof; and

(iv) the Commission in the case of all other municipal securities dealers.

(B) When used with respect to a clearing agency or transfer agent:

(i) the Comptroller of the Currency, in the case of a national bank or a bank operating under the Code of Law for the District of Columbia, or a subsidiary of any such bank;

(ii) the Board of Governors of the Federal Reserve System, in the case of a State member bank of the Federal Reserve System, a subsidiary thereof, a bank holding company, or a subsidiary of a bank holding company which is a bank other than a bank specified in clause (i) or (iii) of this subparagraph;

(iii) the Federal Deposit Insurance Corporation, in the case of a bank insured by the Federal Deposit Insurance Corporation (other than a member of the Federal Reserve System), or a subsidiary thereof; and

(iv) the Commission in the case of all other clearing agencies and transfer agents.

(C) When used with respect to a participant or applicant to become a participant in a clearing agency or a person requesting or having access to services offered by a clearing agency:

(i) the Comptroller of the Currency, in the case of a national bank or a bank operating under the Code of Law for the District of Columbia when the appropriate regulatory agency for such clearing agency is not the Commission;

(ii) the Board of Governors of the Federal Reserve System in the case of a state member bank of the Federal Reserve System, a bank holding company, or a subsidiary of a bank holding company, or a subsidiary of a bank holding company [2] which is a bank other than a bank specified in clause (i) or (iii) of this subparagraph when the appropriate regulatory agency for such clearing agency is not the Commission;

(iii) the Federal Deposit Insurance Corporation, in the case of a bank insured by the Federal Deposit Insurance Corporation (other than a member of the Federal Reserve System) when the appropriate regulatory agency for such clearing agency is not the Commission; and

(iv) the Commission in all other cases.

(D) When used with respect to an institutional investment manager which is a bank the deposits of which are insured in accordance with the Federal Deposit Insurance Act:

(i) the Comptroller of the Currency, in the case of a national bank or a bank operating under the Code of Law for the District of Columbia;

(ii) the Board of Governors of the Federal Reserve System, in the case of any other member bank of the Federal Reserve System; and

(iii) the Federal Deposit Insurance Corporation, in the case of any other insured bank.

(E) When used with respect to a national securities exchange or registered securities association, member thereof, person associated with a member thereof, applicant to become a member thereof or to become associated with a member thereof, or person requesting or having access to services offered by such exchange or association or member thereof, or the Municipal Securities Rulemaking Board, the Commission.

(F) When used with respect to a person exercising investment discretion with respect to an account;

(i) the Comptroller of the Currency, in the case of a national bank or a bank operating under the Code of Law for the District of Columbia;

(ii) the Board of Governors of the Federal Reserve System in the case of any other member bank of the Federal Reserve System;

(iii) the Federal Deposit Insurance Corporation, in the case of any other bank the deposits of which are insured in accordance with the Federal Deposit Insurance Act; and

(iv) the Commission in the case of all other such persons.

As used in this paragraph, the terms "bank holding company" and "subsidiary of a bank holding company" have the meanings given them in section 1841 of Title 12.

(35) A person exercises "investment discretion" with respect to an account if, directly or indirectly, such person (A) is authorized to determine what securities or other property shall be purchased or sold by or for the account, (B) makes decisions as to what securities or other property shall be purchased or sold by or for the account even though some other person may have responsibility for such investment decisions, or (C) otherwise exercises such influence with respect to the purchase and sale of securities or other property by or for the account as the Commission, by rule, determines, in the public interest or for the protection of investors, should be subject to the operation of the provisions of this chapter and the rules and regulations thereunder.

(36) A class of persons or markets is subject to "equal regulation" if no member of the class has a competitive advantage over any other member thereof resulting from a disparity in their regulation under this chapter which the Commission determines is unfair and not necessary or appropriate in furtherance of the purposes of this chapter.

(37) The term "records" means accounts, correspondence, memorandums, tapes, discs, papers, books, and other documents or transcribed information of any type, whether expressed in ordinary or machine language.

(38) The term "market maker" means any specialist permitted to act as a dealer, any dealer acting in the capacity of block positioner, and any dealer who, with respect to a security, holds himself out (by entering quotations in an inter-dealer communications system or otherwise) as being willing to buy and sell such security for his own account on a regular or continuous basis.

(39) A person is subject to a "statutory disqualification" with respect to membership or participation in, or association with a member of, a self-regulatory organization, if such person—

(A) has been and is expelled or suspended from membership or participation in, or barred or suspended from being associated with a member of, any self-regulatory organization;

(B) is subject to an order of the Commission denying, suspending for a period not exceeding twelve months, revoking his registration as a broker, dealer, or municipal securities dealer, or barring his being associated with a broker, dealer, or municipal securities dealer;

(C) by his conduct while associated with a broker, dealer, or municipal securities dealer, has been found to be a cause of any effective suspension, expulsion, or order of the character described in subparagraph (A) or (B) of this paragraph, and in entering such a suspension, expulsion, or order, the Commission or any such self-regulatory organization shall have jurisdiction to find whether or not any person was a cause thereof;

(D) has associated with him any person who is known, or in the exercise of reasonable care should be known, to him to be a person described by subparagraph (A), (B), or (C) of this paragraph; or

(E) has committed or omitted any act enumerated in subparagraph (D) or (E) of paragraph (4) of section 78*o*(b) of this title, has been convicted of any offense specified in subparagraph (B) of such paragraph (4) within ten years of the date of the filing of an application for membership or participation in, or to become associated with a member of, such self-regulatory organization, is enjoined from any action, conduct, or practice specified in subparagraph (C) of such paragraph (4), has willfully made or caused to be made in any application for membership or participation in, or to become associated with a member of, a self-regulatory organization, report required to be filed with a self-regulatory organization, or proceeding before a self-regulatory organization, any statement which was at the time, and in the light of the circumstances under which it was

made, false or misleading with respect to any material fact, or has omitted to state in any such application, report, or proceeding any material fact which is required to be stated therein.

(40) The term "financial responsibility rules" means the rules and regulations of the Commission or the rules and regulations prescribed by any self-regulatory organization relating to financial responsibility and related practices which are designated by the Commission, by rule or regulation, to be financial responsibility rules.

Power to define technical, trade, accounting, and other terms

(b) The Commission and the Board of Governors of the Federal Reserve System, as to matters within their respective jurisdictions, shall have power by rules and regulations to define technical, trade, accounting, and other terms used in this chapter, consistently with the provisions and purposes of this chapter.

Application to governmental departments or agencies

(c) No provision of this chapter shall apply to, or be deemed to include, any executive department or independent establishment of the United States, or any lending agency which is wholly owned, directly or indirectly, by the United States, or any officer, agent, or employee of any such department, establishment, or agency, acting in the course of his official duty as such, unless such provision makes specific reference to such department, establishment, or agency.

Issuers of municipal securities

(d) No issuer of municipal securities or officer or employee thereof acting in the course of his official duties as such shall be deemed to be a "broker", "dealer", or "municipal securities dealer" solely by reason of buying, selling, or effecting transactions in the issuer's securities.

June 6, 1934, c. 404, Title I, § 3, 48 Stat. 882; Aug. 23, 1935, c. 614, § 203(a), 49 Stat. 704; Proc. No. 2695, eff. July 4, 1946, 11 F.R. 7517, 60 Stat. 1352; June 25, 1959, Pub.L. 86–70, § 12(b), 73 Stat. 143; July 12, 1960, Pub.L. 86–624, § 7(b), 74 Stat. 412; Aug. 20, 1964, Pub.L. 88–467, § 2, 78 Stat. 565; Aug. 10, 1970, Pub.L. 91–373, Title IV, § 401(b), 84 Stat. 718; Dec. 14, 1970, Pub.L. 91–547, § 28(a), (b), 84 Stat. 1435; Dec. 22, 1970, Pub.L. 91–567, § 6(b), 84 Stat. 1499; June 4, 1975, Pub.L. 94–29, § 3, 89 Stat. 97; May 21, 1978, Pub.L. 95–283, § 16, 92 Stat. 274; Oct. 21, 1980, Pub.L. 96–477, Title VII, § 702, 94 Stat. 2295.

[1] So in original. Probably should be followed by a comma.
[2] So in original.

Historical Note

References in Text. Section 11(k) of the Federal Reserve Act, as amended, referred to in subsec. (a)(4), which involved the power of the Board of Governors of the Federal Reserve System to allow national banks to act as fiduciaries

of Commission personnel, including Commissioners, to perform such functions as may have been delegated by the Commission to Commission personnel, including Commissioners, pursuant to section 78d-1 of this title.

Pub.L. 87-592, § 2, Aug. 20, 1962, 76 Stat. 395.

Historical Note

References in Text. Reorganization Plan Numbered 10 of 1950 (64 Stat. 1265), referred to in text, is set out as a note under section 78d of this title.

Codification. Section is not part of the Securities Exchange Act of 1934 which comprises this chapter.

Legislative History. For legislative history and purpose of Pub.L. 87-592, see 1962 U.S.Code Cong. and Adm.News, p. 2150.

Rules of Practice for Securities and Exchange Commission

For Rules of Practice for Securities and Exchange Commission, see part 201 of Title 17, Code of Federal Regulations, set out following section 78u of this title.

Code of Federal Regulations

Organization, etc., see 17 CFR 200.1 et seq.

§ 78e. Transactions on unregistered exchanges

It shall be unlawful for any broker, dealer, or exchange, directly or indirectly, to make use of the mails or any means or instrumentality of interstate commerce for the purpose of using any facility of an exchange within or subject to the jurisdiction of the United States to effect any transaction in a security, or to report any such transaction, unless such exchange (1) is registered as a national securities exchange under section 78f of this title, or (2) is exempted from such registration upon application by the exchange because, in the opinion of the Commission, by reason of the limited volume of transactions effected on such exchange, it is not practicable and not necessary or appropriate in the public interest or for the protection of investors to require such registration.

June 6, 1934, c. 404, Title I, § 5, 48 Stat. 885.

Historical Note

Transfer of Functions. For transfer of the functions of the Securities and Exchange Commission, with certain exceptions, to the chairman of such commission, see Reorg.Plan No. 10 of 1950, §§ 1, 2, eff. May 24, 1950, 15 F.R. 3175, 64 Stat. 1265, set out under section 78d of this title.

Cross References

Effective date, see section 78hh of this title.

Code of Federal Regulations

General regulatory policies, see 17 CFR 240.0-1 et seq.

concurring in result.) Hughes v. Dempsey-Tegeler & Co., Inc., C.A.Cal.1976, 534 F.2d 156, certiorari denied 97 S.Ct. 229, 429 U.S. 896, 50 L.Ed.2d 180.

In action by customer against securities broker, claiming violations of this chapter and rules of stock exchange, where complaint did not state a claim under federal law, court of appeals was required to consider dealer's challenge to diversity jurisdiction of federal district court, even though broker did not seek leave to appeal from denial of its motion to dismiss. Colonial Realty Corp. v. Bache & Co., C.A.N.Y.1966, 358 F.2d 178, certiorari denied 87 S.Ct. 40, 385 U.S. 817, 17 L.Ed.2d 56.

59. —— Scope of review

As long as a stock exchange takes prompt action to investigate alleged violations of rules promulgated by it and, having ascertained that violations exist, takes action reasonably designed to restore compliance with those rules, courts considering whether exchange has breached its duties under this section should not substitute their retrospective judgment concerning appropriate action. (Per Renfrew, District Judge, with one Circuit Judge concurring in result.) Hughes v. Dempsey-Tegeler & Co., Inc., C.A.Cal.1976, 534 F.2d 156, certiorari denied 97 S.Ct. 229, 429 U.S. 896, 50 L.Ed.2d 180.

If self-regulatory scheme is to remain operable, antitrust courts must not substitute their judgment for that of particular stock exchange, but there must be foundation in record for action taken by exchange. Zuckerman v. Yount, D.C.Ill. 1973, 362 F.Supp. 858.

60. Findings

Evidence supported finding that manager of local office of stock brokerage corporation and predecessor partnership of corporation had been acting in confidential and fiduciary capacity towards plaintiff with respect to investment of her money, in action for improper handling of plaintiff's account by defendants who had agreed to act as plaintiff's investment counselors and stockbrokers. Twomey v. Mitchum, Jones & Templeton, Inc., Cal.App.1968, 69 Cal.Rptr. 222.

61. Record

A detailed factual record was not required for reviewing court to conclude that the record before the Commission contained substantial evidence to support its decision to approve OBO plan by which securities exchange sought to take action against those order book officials with insufficient staff and to transfer option classes from one official to another to accommodate flow stress or floor congestion. Belenke v. Securities and Exchange Commission, C.A.7, 1979, 606 F.2d 193.

Commission was not required to develop a record not contemplated by this chapter prior to approving OBO plan by which securities exchange sought to take action against those order book officials with insufficient staff and to transfer option classes from one official to another to accommodate flow stress or floor congestion. Id.

§ 78g. Margin requirements

Rules and regulations for extension of credit; standard for initial extension; undermargined accounts

(a) For the purpose of preventing the excessive use of credit for the purchase or carrying of securities, the Board of Governors of the Federal Reserve System shall, prior to October 1, 1934, and from time to time thereafter, prescribe rules and regulations with respect to the amount of credit that may be initially extended and subsequently maintained on any security (other than an exempted security). For the initial extension of credit, such rules and regulations shall be based upon the following standard: An amount not greater than whichever is the higher of—

(1) 55 per centum of the current market price of the security, or

(2) 100 per centum of the lowest market price of the security during the preceding thirty-six calendar months, but not more than 75 per centum of the current market price.

Such rules and regulations may make appropriate provision with respect to the carrying of undermargined accounts for limited periods and under specified conditions; the withdrawal of funds or securities; the substitution or additional purchases of securities; the transfer of accounts from one lender to another; special or different margin requirements for delayed deliveries, short sales, arbitrage transactions, and securities to which paragraph (2) of this subsection does not apply; the bases and the methods to be used in calculating loans, and margins and market prices; and similar administrative adjustments and details. For the purposes of paragraph (2) of this subsection, until July 1, 1936, the lowest price at which a security has sold on or after July 1, 1933, shall be considered as the lowest price at which such security has sold during the preceding thirty-six calendar months.

Lower and higher margin requirements

(b) Notwithstanding the provisions of subsection (a) of this section, the Board of Governors of the Federal Reserve System, may, from time to time, with respect to all or specified securities or transactions, or classes of securities, or classes of transactions, by such rules and regulations (1) prescribe such lower margin requirements for the initial extension or maintenance of credit as it deems necessary or appropriate for the accommodation of commerce and industry, having due regard to the general credit situation of the country, and (2) prescribe such higher margin requirements for the initial extension or maintenance of credit as it may deem necessary or appropriate to prevent the excessive use of credit to finance transactions in securities.

Unlawful credit extension to customers

(c) It shall be unlawful for any member of a national securities exchange or any broker or dealer, directly or indirectly, to extend or maintain credit or arrange for the extension or maintenance of credit to or for any customer—

(1) on any security (other than an exempted security), in contravention of the rules and regulations which the Board of Governors of the Federal Reserve System shall prescribe under subsections (a) and (b) of this section;

(2) without collateral or on any collateral other than securities, except in accordance with such rules and regulations as the Board of Governors of the Federal Reserve System may prescribe (A) to permit under specified conditions and for a limited period any such member, broker, or dealer to maintain a credit initially extended in conformity with the rules and regu-

lations of the Board of Governors of the Federal Reserve System, and (B) to permit the extension or maintenance of credit in cases where the extension or maintenance of credit is not for the purpose of purchasing or carrying securities or of evading or circumventing the provisions of paragraph (1) of this subsection.

Unlawful credit extension in violation of rules and regulations; exception to application of rules, etc.

(d) It shall be unlawful for any person not subject to subsection (c) of this section to extend or maintain credit or to arrange for the extension or maintenance of credit for the purpose of purchasing or carrying any security, in contravention of such rules and regulations as the Board of Governors of the Federal Reserve System shall prescribe to prevent the excessive use of credit for the purchasing or carrying of or trading in securities in circumvention of the other provisions of this section. Such rules and regulations may impose upon all loans made for the purpose of purchasing or carrying securities limitations similar to those imposed upon members, brokers, or dealers by subsection (c) of this section and the rules and regulations thereunder. This subsection and the rules and regulations thereunder shall not apply (A) to a loan made by a person not in the ordinary course of his business, (B) to a loan on an exempted security, (C) to a loan to a dealer to aid in the financing of the distribution of securities to customers not through the medium of a national securities exchange, (D) to a loan by a bank on a security other than an equity security, or (E) to such other loans as the Board of Governors of the Federal Reserve System shall, by such rules and regulations as it may deem necessary or appropriate in the public interest or for the protection of investors, exempt, either unconditionally or upon specified terms and conditions or for stated periods, from the operation of this subsection and the rules and regulations thereunder.

Effective date of this section and rules and regulations

(e) The provisions of this section or the rules and regulations thereunder shall not apply on or before July 1, 1937, to any loan or extension of credit made prior to June 6, 1934 or to the maintenance, renewal, or extension of any such loan or credit, except to the extent that the Board of Governors of the Federal Reserve System may by rules and regulations prescribe as necessary to prevent the circumvention of the provisions of this section or the rules and regulations thereunder by means of withdrawals of funds or securities, substitutions of securities, or additional purchases or by any other device.

Unlawful receipt of credit; exemptions

(f)(1) It is unlawful for any United States person, or any foreign person controlled by a United States person or acting on behalf of

or in conjunction with such person, to obtain, receive, or enjoy the beneficial use of a loan or other extension of credit from any lender (without regard to whether the lender's office or place of business is in a State or the transaction occurred in whole or in part within a State) for the purpose of (A) purchasing or carrying United States securities, or (B) purchasing or carrying within the United States of any other securities, if, under this section or rules and regulations prescribed thereunder, the loan or other credit transaction is prohibited or would be prohibited if it had been made or the transaction had otherwise occurred in a lender's office or other place of business in a State.

(2) For the purposes of this subsection—

(A) The term "United States person" includes a person which is organized or exists under the laws of any State or, in the case of a natural person, a citizen or resident of the United States; a domestic estate; or a trust in which one or more of the foregoing persons has a cumulative direct or indirect beneficial interest in excess of 50 per centum of the value of the trust.

(B) The term "United States security" means a security (other than an exempted security) issued by a person incorporated under the laws of any State, or whose principal place of business is within a State.

(C) The term "foreign person controlled by a United States person" includes any noncorporate entity in which United States persons directly or indirectly have more than a 50 per centum beneficial interest, and any corporation in which one or more United States persons, directly or indirectly, own stock possessing more than 50 per centum of the total combined voting power of all classes of stock entitled to vote, or more than 50 per centum of the total value of shares of all classes of stock.

(3) The Board of Governors of the Federal Reserve System may, in its discretion and with due regard for the purposes of this section, by rule or regulation exempt any class of United States persons or foreign persons controlled by a United States person from the application of this subsection.

June 6, 1934, c. 404, Title I, § 7, 48 Stat. 886; Aug. 23, 1935, c. 614, § 203(a), 49 Stat. 704; July 29, 1968, Pub.L. 90–437, 82 Stat. 452; Oct. 26, 1970, Pub.L. 91–508, Title III, § 301(a), 84 Stat. 1124.

Historical Note

1970 Amendment. Subsec. (f). Pub.L. 91–508 added subsec. (f).

1968 Amendment. Subsec. (a). Pub.L. 90–437, § 1(1), struck out "registered on a national securities exchange" following "(other than an exempted security)".

Subsec. (c). Pub.L. 90–437, § 1(2), struck out "who transacts a business in securities through the medium of any such member" following "any broker or dealer", in par. (1) struck out "registered on a national securities exchange" follow-

§ 78i. Manipulation of security prices

Transactions relating to purchase or sale of security

(a) It shall be unlawful for any person, directly or indirectly, by the use of the mails or any means or instrumentality of interstate commerce, or of any facility of any national securities exchange, or for any member of a national securities exchange—

(1) For the purpose of creating a false or misleading appearance of active trading in any security registered on a national securities exchange, or a false or misleading appearance with respect to the market for any such security, (A) to effect any transaction in such security which involves no change in the beneficial ownership thereof, or (B) to enter an order or orders for the purchase of such security with the knowledge that an order or orders of substantially the same size, at substantially the same time, and at substantially the same price, for the sale of any such security, has been or will be entered by or for the same or different parties, or (C) to enter any order or orders for the sale of any such security with the knowledge that an order or orders of substantially the same size, at substantially the same time, and at substantially the same price, for the purchase of such security, has been or will be entered by or for the same or different parties.

(2) To effect, alone or with one or more other persons, a series of transactions in any security registered on a national securities exchange creating actual or apparent active trading in such security or raising or depressing the price of such security, for the purpose of inducing the purchase or sale of such security by others.

(3) If a dealer or broker, or other person selling or offering for sale or purchasing or offering to purchase the security, to induce the purchase or sale of any security registered on a national securities exchange by the circulation or dissemination in the ordinary course of business of information to the effect that the price of any such security will or is likely to rise or fall because of market operations of any one or more persons conducted for the purpose of raising or depressing the prices of such security.

(4) If a dealer or broker, or other person selling or offering for sale or purchasing or offering to purchase the security, to make, regarding any security registered on a national securities exchange, for the purpose of inducing the purchase or sale of such security, any statement which was at the time and in the light of the circumstances under which it was made, false or misleading with respect to any material fact, and which he knew or had reasonable ground to believe was so false or misleading.

(5) For a consideration, received directly or indirectly from a dealer or broker, or other person selling or offering for sale or purchasing or offering to purchase the security, to induce the purchase or sale of any security registered on a national securities exchange by the circulation or dissemination of information to the effect that the price of any such security will or is likely to rise or fall because of the market operations of any one or more persons conducted for the purpose of raising or depressing the price of such security.

(6) To effect either alone or with one or more other persons any series of transactions for the purchase and/or sale of any security registered on a national securities exchange for the purpose of pegging, fixing, or stabilizing the price of such security in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Transactions relating to puts, calls, straddles, or options

(b) It shall be unlawful for any person to effect, by use of any facility of a national securities exchange, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors—

(1) any transaction in connection with any security whereby any party to such transaction acquires any put, call, straddle, or other option or privilege of buying the security from or selling the security to another without being bound to do so; or

(2) any transaction in connection with any security with relation to which he has, directly or indirectly, any interest in any such put, call, straddle, option, or privilege; or

(3) any transaction in any security for the account of any person who he has reason to believe has, and who actually has, directly or indirectly, any interest in any such put, call, straddle, option, or privilege with relation to such security.

Endorsement or guarantee of puts, calls, straddles, or options

(c) It shall be unlawful for any member of a national securities exchange directly or indirectly to endorse or guarantee the performance of any put, call, straddle, option, or privilege in relation to any security registered on a national securities exchange, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Registered warrant, right, or convertible security not included in "put", "call", "straddle", or "option"

(d) The terms "put", "call", "straddle", "option", or "privilege" as used in this section shall not include any registered warrant, right, or convertible security.

Persons liable; suits at law or in equity

(e) Any person who willfully participates in any act or transaction in violation of subsections (a), (b), or (c) of this section, shall be liable to any person who shall purchase or sell any security at a price which was affected by such act or transaction, and the person so injured may sue in law or in equity in any court of competent jurisdiction to recover the damages sustained as a result of any such act or transaction. In any such suit the court may, in its discretion, require an undertaking for the payment of the costs of such suit, and assess reasonable costs, including reasonable attorneys' fees, against either party litigant. Every person who becomes liable to make any payment under this subsection may recover contribution as in cases of contract from any person who, if joined in the original suit, would have been liable to make the same payment. No action shall be maintained to enforce any liability created under this section, unless brought within one year after the discovery of the facts constituting the violation and within three years after such violation.

Section not applicable to exempted securities

(f) The provisions of this section shall not apply to an exempted security.

June 6, 1934, c. 404, Title I, § 9, 48 Stat. 889.

§ 78i. Manipulation of security prices

[See main volume for text of (a) to (e)]

Subsection (a) not applicable to exempted securities

(f) The provisions of subsection (a) of this section shall not apply to an exempted security.

Foreign currencies

(g) Notwithstanding any other provision of law, the Commission shall have the authority to regulate the trading of any put, call, straddle, option, or privilege on any security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency (but not, with respect to any of the foregoing, an option on a contract for future delivery).

As amended Oct. 13, 1982, Pub.L. 97–303, § 3, 96 Stat. 1409.

1982 Amendment. Subsec. (f). Pub.L. 97–303, § 3(1), substituted "The provisions of subsection (a) of this section shall not apply" for "The provisions of this section shall not apply".

Subsec. (g). Pub.L. 97–303, § 3(2), added subsec. (g).

Legislative History. For legislative history and purpose of Pub.L. 97–303, see 1982 U.S.Code Cong. and Adm.News, p. 2780.

Federal Practice and Procedure

Regulation of costs in criminal and civil matters, see Wright & Miller: Civil § 2670.

38. Complaint—Generally

To make out a violation of subsec. (a)(1) of this section in a private action under subsec. (e) of this section a plaintiff must prove existence of a wash sale or matched orders in a security done with scienter for the purpose of creating a false or misleading appearance of active trading in that security on which plaintiff relied that affected plaintiff's purchase or selling price. Chemetron Corp. v. Business Funds, Inc., C.A.Tex.1982, 682 F.2d 1149, rehearing denied 689 F.2d 190.

39. —— Limitations

Claim against stock exchanges for market manipulation was time-barred, where it was brought more than three years after the last event underlying the claim, and failure to discover the wrong during that three-year time period did not toll the statute of limitations. Walck v. American Stock Exchange, Inc., C.A.Pa. 1982, 687 F.2d 778.

56. Attorney fees

Nemeroff v. Abelson, 620 F.2d 339 [main volume] on remand 94 F.R.D. 136.

§ 78j. Manipulative and deceptive devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

(a) To effect a short sale, or to use or employ any stop-loss order in connection with the purchase or sale, of any security registered on a national securities exchange, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

June 6, 1934, c. 404, Title I, § 10, 48 Stat. 891.

Historical Note

Transfer of Functions. For transfer of the functions of the Securities and Exchange Commission, with certain exceptions, to the chairman of such commission, see Reorg.Plan No. 10 of 1950, §§ 1, 2, eff. May 24, 1950, 15 F.R. 3173, 64 Stat. 1265, set out under section 78d of this title

tle v. Gamble-Skogmo, Inc., D.C.N.Y.1972. 348 F.Supp. 979, modified on other grounds 478 F.2d 1281.

Interest on sums due plaintiff-stockholders for loss sustained in relying on false and misleading proxy statement issued to secure plaintiffs' votes in favor of corporate merger was to be computed on gross amounts due plaintiff rather than on net amounts after defendant had been given credit for value of defendant's preferred stock received by plaintiffs on merger. Id.

327. —— Mitigation

Even if plaintiff corporation had discovered, prior to purchasing some of shares of target corporation, that defendant corporation was competing unfairly in attempting to purchase majority shares of target corporation, plaintiff was not required to mitigate damages by dropping out of the contest, since if persistence in the fight, despite the violations, had brought it victory, it would not have sustained damages from being put in a minority shareholder's position. Chris-Craft Industries, Inc. v. Piper Aircraft Corp., C.A.N.Y.1973, 480 F.2d 341, certiorari denied 94 S.Ct. 231, 232, 234, 414 U.S. 910, 924, 38 L.Ed.2d 148, 158, on remand 384 F.Supp. 507.

At time registration statement became effective following merger, plaintiff shareholders of stock of acquired corporation came under an obligation to mitigate their damages arising out of their acquiescence in merger caused by material omissions in proxy material and a 30-day period following such date was a reasonable time in which plaintiffs should have disposed of their shares of acquiring corporation so as to mitigate damages; any plaintiff holding shares of acquired corporation after the 30-day period was considered by court, for purpose of fixing damages, to have made a new investment decision. Pierre J. LeLandais & Co., Inc. v. MDS-ATRON, Inc., D.C.N.Y.1974, 387 F.Supp. 1310, affirmed in part, reversed in part on other grounds 543 F.2d 421, certiorari denied 97 S.Ct. 786, 429 U.S. 1062, 50 L.Ed.2d 777.

328. —— Out-of-pocket losses

Where corporation whose directors had been elected through the use of proxy statements which omitted material information was no longer extant, proper remedy was not disgorgement of profits realized from the nondisclosed activities but rather payment of out-of-pocket losses sustained by corporation as a result of the nondisclosed activities. Ohio Drill & Tool Co. v. Johnson, C.A.Ohio 1974, 498 F.2d 186.

Out-of-pocket losses need not be shown to have resulted from issuance of misleading proxy statements in order for relief to be granted in derivative action brought against directors. Id.

Expenses of preparing and mailing allegedly defective proxy statements, directors' fees and expenses paid to directors, and compensation paid to directors would have been correct in any event as part of corporation's annual election process and, hence, were not recoverable as out-of-pocket damages in suit under this section governing filing of false and misleading statements in connection with proxy materials. Maldonado v. Flynn, D.C.N.Y. 1979, 477 F.Supp. 1007.

Expense of a new proxy solicitation in event it was ordered by court was only expense which could be said to represent out-of-pocket losses attributable to allegedly false proxy statements in connection with election of board of directors and, hence, was only expense which was recoverable as damages. Id.

329. Restitution

Where stockholders in out-door advertising corporation were defrauded by voting for merger with dominating majority stockholder without vital information withheld by insiders, stockholders would be entitled to restitution. Gerstle v. Gamble-Skogmo, Inc., D.C.N.Y.1969, 298 F.Supp. 66, modified on other grounds 478 F.2d 1281.

§ 78o. Registration and regulation of brokers and dealers

Registration of all persons utilizing exchange facilities to effect transactions; exemptions

(a)(1) It shall be unlawful for any broker or dealer which is either a person other than a natural person or a natural person not associated with a broker or dealer which is a person other than a natural person (other than such a broker or dealer whose business

is exclusively intrastate and who does not make use of any facility of a national securities exchange) to make use of the mails or any means or instrumentality of interstate commerce to effect any transactions in, or to induce or attempt to induce the purchase or sale of, any security (other than an exempted security or commercial paper, bankers' acceptances, or commercial bills) unless such broker or dealer is registered in accordance with subsection (b) of this section.

(2) The Commission, by rule or order, as it deems consistent with the public interest and the protection of investors, may conditionally or unconditionally exempt from paragraph (1) of this subsection any broker or dealer or class of brokers or dealers specified in such rule or order.

Manner of registration of brokers and dealers

(b)(1) A broker or dealer may be registered by filing with the Commission an application for registration in such form and containing such information and documents concerning such broker or dealer and any persons associated with such broker or dealer as the Commission, by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors. Within forty-five days of the date of the filing of such application (or within such longer period as to which the applicant consents), the Commission shall—

(A) by order grant registration, or

(B) institute proceedings to determine whether registration should be denied. Such proceedings shall include notice of the grounds for denial under consideration and opportunity for hearing and shall be concluded within one hundred twenty days of the date of the filing of the application for registration. At the conclusion of such proceedings, the Commission, by order, shall grant or deny such registration. The Commission may extend the time for conclusion of such proceedings for up to ninety days if it finds good cause for such extension and publishes its reasons for so finding or for such longer period as to which the applicant consents.

The Commission shall grant such registration if the Commission finds that the requirements of this section are satisfied. The Commission shall deny such registration if it does not make such a finding or if it finds that if the applicant were so registered, its registration would be subject to suspension or revocation under paragraph (4) of this subsection.

(2)(A) An application for registration of a broker or dealer to be formed or organized may be made by a broker or dealer to which the broker or dealer to be formed or organized is to be the successor. Such application, in such form as the Commission, by rule, may prescribe, shall contain such information and documents concerning

the applicant, the successor, and any persons associated with the applicant or the successor, as the Commission, by rule, may prescribe as necessary or appropriate in the public interest or for the protection of investors. The grant or denial of registration to such an applicant shall be in accordance with the procedures set forth in paragraph (1) of this subsection. If the Commission grants such registration, the registration shall terminate on the forty-fifth day after the effective date thereof, unless prior thereto the successor shall, in accordance with such rules and regulations as the Commission may prescribe, adopt the application for registration as its own.

(B) Any person who is a broker or dealer solely by reason of acting as a municipal securities dealer or municipal securities broker, who so acts through a separately identifiable department or division, and who so acted in such a manner on June 4, 1975, may, in accordance with such terms and conditions as the Commission, by rule, prescribes as necessary and appropriate in the public interest and for the protection of investors, register such separately identifiable department or division in accordance with this subsection. If any such department or division is so registered, the department or division and not such person himself shall be the broker or dealer for purposes of this chapter.

(C) Within six months of the date of the granting of registration to a broker or dealer, the Commission, or upon the authorization and direction of the Commission, a registered securities association or national securities exchange of which such broker or dealer is a member, shall conduct an inspection of the broker or dealer to determine whether it is operating in conformity with the provisions of this chapter and the rules and regulations thereunder: *Provided, however*, That the Commission may delay such inspection of any class of brokers or dealers for a period not to exceed six months.

(3) Any provision of this chapter (other than section 78e of this title and subsection (a) of this section) which prohibits any act, practice, or course of business if the mails or any means or instrumentality of interstate commerce is used in connection therewith shall also prohibit any such act, practice, or course of business by any registered broker or dealer or any person acting on behalf of such a broker or dealer, irrespective of any use of the mails or any means or instrumentality of interstate commerce in connection therewith.

(4) The Commission, by order, shall censure, place limitations on the activities, functions, or operations of, suspend for a period not exceeding twelve months, or revoke the registration of any broker or dealer if it finds, on the record after notice and opportunity for hearing, that such censure, placing of limitations, suspension, or revocation is in the public interest and that such broker or dealer, whether prior or subsequent to becoming such, or any person asso-

ciated with such broker or dealer, whether prior or subsequent to becoming so associated—

(A) has willfully made or caused to be made in any application for registration or report required to be filed with the Commission under this chapter, or in any proceeding before the Commission with respect to registration, any statement which was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, or has omitted to state in any such application or report any material fact which is required to be stated therein.

(B) has been convicted within ten years preceding the filing of any application for registration or at any time thereafter of any felony or misdemeanor which the Commission finds—

(i) involves the purchase or sale of any security, the taking of a false oath, the making of a false report, bribery, perjury, burglary, or conspiracy to commit any such offense;

(ii) arises out of the conduct of the business of a broker, dealer, municipal securities dealer, investment adviser, bank, insurance company, or fiduciary;

(iii) involves the larceny, theft, robbery, extortion, forgery, counterfeiting, fraudulent concealment, embezzlement, fraudulent conversion, or misappropriation of funds, or securities; or

(iv) involves the violation of section 152, 1341, 1342, or 1343 or chapter 25 or 47 of Title 18.

(C) is permanently or temporarily enjoined by order, judgment, or decree of any court of competent jurisdiction from acting as an investment adviser, underwriter, broker, dealer, or municipal securities dealer, or as an affiliated person or employee of any investment company, bank, or insurance company, or from engaging in or continuing any conduct or practice in connection with any such activity, or in connection with the purchase or sale of any security.

(D) has willfully violated any provision of the Securities Act of 1933, the Investment Advisers Act of 1940, the Investment Company Act of 1940, this chapter, the rules or regulations under any of such statutes, or the rules of the Municipal Securities Rulemaking Board, or is unable to comply with any such provision.

(E) has willfully aided, abetted, counseled, commanded, induced, or procured the violation by any other person of any provision of the Securities Act of 1933, the Investment Advisers Act of 1940, the Investment Company Act of 1940, this chapter, the rules or regulations under any of such statutes, or the rules of the Municipal Securities Rulemaking Board, or has failed

reasonably to supervise, with a view to preventing violations of the provisions of such statutes, rules, and regulations, another person who commits such a violation, if such other person is subject to his supervision. For the purposes of this subparagraph (E) no person shall be deemed to have failed reasonably to supervise any other person, if—

(i) there have been established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any such violation by such other person, and

(ii) such person has reasonably discharged the duties and obligations incumbent upon him by reason of such procedures and system without reasonable cause to believe that such procedures and system were not being complied with.

(F) is subject to an order of the Commission entered pursuant to paragraph (6) of this subsection (b) barring or suspending the right of such person to be associated with a broker or dealer.

(5) Pending final determination whether any registration under this subsection shall be revoked, the Commission, by order, may suspend such registration, if such suspension appears to the Commission, after notice and opportunity for hearing, to be necessary or appropriate in the public interest or for the protection of investors. Any registered broker or dealer may, upon such terms and conditions as the Commission deems necessary or appropriate in the public interest or for the protection of investors, withdraw from registration by filing a written notice of withdrawal with the Commission. If the Commission finds that any registered broker or dealer is no longer in existence or has ceased to do business as a broker or dealer, the Commission, by order, shall cancel the registration of such broker or dealer.

(6) The Commission, by order, shall censure or place limitations on the activities or functions of any person associated, or seeking to become associated, with a broker or dealer, or suspend for a period not exceeding twelve months or bar any such person from being associated with a broker or dealer, if the Commission finds, on the record after notice and opportunity for hearing, that such censure, placing of limitations, suspension, or bar is in the public interest and that such person has committed or omitted any act or omission enumerated in subparagraph (A), (D), or (E) of paragraph (4) of this subsection, has been convicted of any offense specified in subparagraph (B) of said paragraph (4) within ten years of the commencement of the proceedings under this paragraph, or is enjoined from any action, conduct, or practice specified in subparagraph (C) of said paragraph (4). It shall be unlawful for any person as to whom such an order suspending or barring him from being associat-

ed with a broker or dealer is in effect willfully to become, or to be, associated with a broker or dealer without the consent of the Commission, and it shall be unlawful for any broker or dealer to permit such a person to become, or remain, a person associated with him without the consent of the Commission, if such broker or dealer knew, or in the exercise of reasonable care should have known, of such order.

(7) No registered broker or dealer shall effect any transaction in, or induce the purchase or sale of, any security unless such broker or dealer meets such standards of operational capability and such broker or dealer and all natural persons associated with such broker or dealer meet such standards of training, experience, competence, and such other qualifications as the Commission finds necessary or appropriate in the public interest or for the protection of investors. The Commission shall establish such standards by rules and regulations, which may—

(A) specify that all or any portion of such standards shall be applicable to any class of brokers and dealers and persons associated with brokers and dealers;

(B) require persons in any such class to pass tests prescribed in accordance with such rules and regulations, which tests shall, with respect to any class of partners, officers, or supervisory employees (which latter term may be defined by the Commission's rules and regulations and as so defined shall include branch managers of brokers or dealers) engaged in the management of the broker or dealer, include questions relating to bookkeeping, accounting, internal control over cash and securities, supervision of employees, maintenance of records, and other appropriate matters; and

(C) provide that persons in any such class other than brokers and dealers and partners, officers, and supervisory employees of brokers or dealers, may be qualified solely on the basis of compliance with such standards of training and such other qualifications as the Commission finds appropriate.

The Commission, by rule, may prescribe reasonable fees and charges to defray its costs in carrying out this paragraph, including, but not limited to, fees for any test administered by it or under its direction. The Commission may cooperate with registered securities associations and national securities exchanges in devising and administering tests and may require registered brokers and dealers and persons associated with such brokers and dealers to pass tests administered by or on behalf of any such association or exchange and to pay such association or exchange reasonable fees or charges to defray the costs incurred by such association or exchange in administering such tests.

(8) In addition to the fees and charges authorized by paragraph (7) of this subsection, each registered broker or dealer not a mem-

ber of a registered securities association shall pay to the Commission such reasonable fees and charges as may be necessary to defray the costs of the additional regulatory duties required to be performed by the Commission because such broker or dealer effects transactions in securities otherwise than on a national securities exchange of which it is a member and is not a member of a registered securities association. The Commission, by rule, shall establish such fees and charges.

(9) No broker or dealer subject to paragraph (8) of this subsection shall effect any transaction in, or induce the purchase or sale of, any security (otherwise than on a national securities exchange of which it is a member) in contravention of such rules and regulations as the Commission may prescribe designed to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest.

(10) For the purposes of determining whether a person is subject to a statutory disqualification under section 78f(c)(2), 78o–3(g)(2), or 78q–1(b)(4)(B) of this title, the term "Commission" in paragraph (4)(B) of this subsection shall mean "exchange", "association", or "clearing agency", respectively.

Use of manipulative or deceptive devices; contravention of rules and regulations

(c)(1) No broker or dealer shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any security (other than commercial paper, bankers' acceptances, or commercial bills) otherwise than on a national securities exchange of which it is a member by means of any manipulative, deceptive, or other fraudulent device or contrivance, and no municipal securities dealer shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any municipal security by means of any manipulative, deceptive, or other fraudulent device or contrivance. The Commission shall, for the purposes of this paragraph, by rules and regulations define such devices or contrivances as are manipulative, deceptive, or otherwise fraudulent.

(2) No broker or dealer shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any security (other than an exempted security or commercial paper, bankers' acceptances, or commercial bills) otherwise than on a national securities exchange of which it is a member, in connection with which such broker or dealer engages in any fraudulent, deceptive, or manipulative act or practice, or makes any fictitious quotation,

and no municipal securities dealer shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any municipal security in connection with which such municipal securities dealer engages in any fraudulent, deceptive, or manipulative act or practice, or makes any fictitious quotation. The Commission shall, for the purposes of this paragraph, by rules and regulations define, and prescribe means reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative and such quotations as are fictitious.

(3) No broker or dealer shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any security (other than an exempted security or commercial paper, bankers' acceptances, or commercial bills) in contravention of such rules and regulations as the Commission shall prescribe as necessary or appropriate in the public interest or for the protection of investors to provide safeguards with respect to the financial responsibility and related practices of brokers and dealers including, but not limited to, the acceptance of custody and use of customers' securities and the carrying and use of customers' deposits or credit balances. Such rules and regulations shall (A) require the maintenance of reserves with respect to customers' deposits or credit balances, and (B) no later than September 1, 1975, establish minimum financial responsibility requirements for all brokers and dealers.

(4) If the Commission finds, after notice and opportunity for hearing, that any person subject to the provisions of section 78*l* or 78m of this title or subsection (d) of this section or any rule or regulation thereunder has failed to comply with any such provision, rule, or regulation in any material respect, the Commission may publish its findings and issue an order requiring such person to comply with such provision or such rule or regulation thereunder upon such terms and conditions and within such time as the Commission may specify in such order.

(5) No dealer (other than a specialist registered on a national securities exchange) acting in the capacity of market maker or otherwise shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any security (other than an exempted security or a municipal security) in contravention of such specified and appropriate standards with respect to dealing as the Commission, by rule, shall prescribe as necessary or appropriate in the public interest and for the protection of investors, to maintain fair and orderly markets, or to remove impediments to and perfect the mechanism of a national market system. Under the rules of the Commission a dealer in a security may be prohibited from acting as a broker in that security.

(6) No broker or dealer shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce or attempt to induce the purchase or sale of, any security (other than an exempted security, municipal security, commercial paper, bankers' acceptances, or commercial bills) in contravention of such rules and regulations as the Commission shall prescribe as necessary or appropriate in the public interest and for the protection of investors or to perfect or remove impediments to a national system for the prompt and accurate clearance and settlement of securities transactions, with respect to the time and method of, and the form and format of documents used in connection with, making settlements of and payments for transactions in securities, making transfers and deliveries of securities, and closing accounts. Nothing in this paragraph shall be construed (A) to affect the authority of the Board of Governors of the Federal Reserve System, pursuant to section 78g of this title, to prescribe rules and regulations for the purpose of preventing the excessive use of credit for the purchase or carrying of securities, or (B) to authorize the Commission to prescribe rules or regulations for such purpose.

Filing of supplementary and periodic information

(d) Each issuer which has filed a registration statement containing an undertaking which is or becomes operative under this subsection as in effect prior to August 20, 1964, and each issuer which shall after such date file a registration statement which has become effective pursuant to the Securities Act of 1933, as amended, shall file with the Commission, in accordance with such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, such supplementary and periodic information, documents, and reports as may be required pursuant to section 78m of this title in respect of a security registered pursuant to section 78*l* of this title. The duty to file under this subsection shall be automatically suspended if and so long as any issue of securities of such issuer is registered pursuant to section 78*l* of this title. The duty to file under this subsection shall also be automatically suspended as to any fiscal year, other than the fiscal year within which such registration statement became effective, if, at the beginning of such fiscal year, the securities of each class to which the registration statement relates are held of record by less than three hundred persons. For the purposes of this subsection, the term "class" shall be construed to include all securities of an issuer which are of substantially similar character and the holders of which enjoy substantially similar rights and privileges. The Commission may, for the purpose of this subsection, define by rules and regulations the term "held of record" as it deems necessary or appropriate in the public interest or for the protection of investors in order to prevent circumvention of the provisions of this subsection. Nothing in this subsection shall

apply to securities issued by a foreign government or political subdivision thereof.

Compliance with this chapter by members not required to be registered

(e) The Commission, by rule, as it deems necessary or appropriate in the public interest and for the protection of investors or to assure equal regulation, may require any member of a national securities exchange not required to register under this section and any person associated with any such member to comply with any provision of this chapter (other than subsection (a) of this section) or the rules or regulations thereunder which by its terms regulates or prohibits any act, practice, or course of business by a "broker or dealer" or "registered broker or dealer" or a "person associated with a broker or dealer," respectively.

June 6, 1934, c. 404, Title I, § 15, 48 Stat. 895; May 27, 1936, c. 462, § 3, 49 Stat. 1377; June 25, 1938, c. 677, § 2, 52 Stat. 1075; Aug. 20, 1964, Pub.L. 88–467, § 6, 78 Stat. 570–574; Dec. 30, 1970, Pub.L. 91–598, § 11(d), formerly § 7(d), 84 Stat. 1653, renumbered Pub.L. 95–283, § 9, May 21, 1978, 92 Stat. 260; June 4, 1975, Pub.L. 94–29, § 11, 89 Stat. 121; Dec. 19, 1977, Pub.L. 95–213, Title II, § 204, 91 Stat. 1500.

Historical Note

Reference in Text. This chapter, referred to in subsecs. (b)(2)(B), (C), (3), (4)(A), (D), (E), and (e), in the original read "this title". See References in Text note under section 78a of this title.

The Securities Act of 1933, referred to in subsecs. (b)(4)(D), (E) and (d), is Act May 27, 1933, c. 38, Title I, 48 Stat. 74, which is classified generally to subchapter I (section 77a et seq.) of chapter 2A of this title. For complete classification of this Act to the Code, see section 77a of this title and Tables volume.

The Investment Advisers Act of 1940, referred to in subsec. (b)(4)(D), (E), is Title II of Act Aug. 22, 1940, c. 686, 54 Stat. 847, which is classified generally to subchapter II (section 80b-1 et seq.) of chapter 2D of this title. For complete classification of this Act to the Code, see section 80b-20 of this title and Tables volume.

The Investment Company Act of 1940, referred to in subsec. (b)(4)(D), (E), is Title I of Act Aug. 22, 1940, c. 686, 54 Stat. 789, which is classified generally to subchapter I (section 80a-1 et seq.) of chapter 2D of this title. For complete classification of this Act to the Code, see section 80a-51 of this title and Tables volume.

1977 Amendment. Subsec. (d). Pub.L. 95–213 authorized the Commission to define, for purposes of this subsection, the term "held of record".

1975 Amendment. Subsec. (a). Pub.L. 94–29, § 11(2), required registration with the Commission of all persons utilizing an exchange's facilities to effect transactions.

Subsec. (b). Pub.L. 94–29, § 11(2), expanded coverage to include municipal securities dealers, permitted non-bank municipal securities dealers and brokers to register company departments or divisions conducting municipal securities activities rather than the company of which the department or division is a part, subjected municipal securities and associated persons thereof to the Commission's enforcement and disciplinary powers, updated the list of statutory offenses which bar a person from becoming a broker-dealer or an associated person of a broker-dealer, expanded Commission regulatory control to include all brokers and dealers executing transactions on exchanges of which such brokers and dealers are not members, required any registered broker-dealer who is not a member of a registered securities association to pay the Commission fees imposed by it to defray the costs of the additional regulatory duties to be performed by the Commission, and clarified the power of national securities exchanges, registered securities associations, and registered

That Commission had taken no action on prior violation of securities legislation by two principal owners of unregistered corporate securities dealer did not estop Commission from denying corporation's application for license as broker-dealer on that ground. Id.

§ 78aa. Jurisdiction of offenses and suits

The district courts of the United States, and the United States courts of any Territory or other place subject to the jurisdiction of the United States shall have exclusive jurisdiction of violations of this chapter or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this chapter or the rules and regulations thereunder. Any criminal proceeding may be brought in the district wherein any act or transaction constituting the violation occurred. Any suit or action to enforce any liability or duty created by this chapter or rules and regulations thereunder, or to enjoin any violation of such chapter or rules and regulations, may be brought in any such district or in the district wherein the defendant is found or is an inhabitant or transacts business, and process in such cases may be served in any other district of which the defendant is an inhabitant or wherever the defendant may be found. Judgments and decrees so rendered shall be subject to review as provided in sections 1254, 1291, and 1292 of Title 28. No costs shall be assessed for or against the Commission in any proceeding under this chapter brought by or against it in the Supreme Court or such other courts.

June 6, 1934, c. 404, Title I, § 27, 48 Stat. 902; June 25, 1936, c. 804, 49 Stat. 1921; June 25, 1948, c. 646, § 32(b), 62 Stat. 991; May 24, 1949, c. 139, § 127, 63 Stat. 107.

Historical Note

References in Text. This chapter, referred to in text, in the original read "this title". See References in Text under 78a of this title.

Codification. The words "the district court of the United States for the District of Columbia" following "The district courts of the United States" have been deleted as superfluous in view of section 132(a) of Title 28, Judiciary and Judicial Procedure, which states that "There shall be in each judicial district a district court which shall be a court of record known as the United States District Court for the district", and section 88 of Title 28 which states that "The District of Columbia constitutes one judicial district".

Act June 25, 1936 substituted "district court of the United States for the District of Columbia" for "Supreme Court of the District of Columbia".

Reference to "sections 1254, 1291, and 1292 of Title 28" was substituted for "sections 128 and 240 of the Judicial Code, as amended (U.S.C.A., Title 28, secs. 225 and 347)" on authority of Act June 25, 1948, c. 646, 62 Stat. 869, the first section of which enacted Title 28.

Transfer of Functions. For transfer of the functions of the Securities and Exchange Commission, with certain exceptions, to the chairman of such commission, see Reorg. Plan No. 10 of 1950, §§ 1, 2, eff. May 24, 1950, 15 F.R. 3175, 64 Stat. 1265, set out under section 78d of this title.

Legislative History. For legislative history and purpose of Act May 24, 1949, see 1949 U.S.Code Cong.Service p. 1248.

Cross References

Jurisdiction of offenses and suits under—

Investment Advisers Act of 1940, see section 80b-14 of this title.

Investment Company Act of 1940, see section 80a-43 of this title.

v. Alison Realty Trust, D.C.Ill.1973, 383 F.Supp. 1256.

Establishment by plaintiffs, in stockholders' derivative action, of their claim under state law for fraud and deceit would entitle them to punitive damages, notwithstanding the fact that the recovery of punitive damages is barred under the federal securities laws. In re Caesars Palace Securities Litigation, D.C.Pa.1973, 360 F.Supp. 366.

Punitive damages may not be recovered under common-law doctrines for conduct actionable under federal securities laws. Schaefer v. First Nat. Bank of Lincolnwood, D.C.Ill.1970, 326 F.Supp. 1186, appeal dismissed 465 F.2d 234.

Punitive damages may not be recovered by a plaintiff in an action against a broker based on violation of this chapter. Meisel v. North Jersey Trust Co. of Ridgewood, N. J., D.C.N.Y.1963, 216 F.Supp. 469.

17. Weight and sufficiency of evidence

In action to recover for fraudulently induced sales by mixed-blood Indians of stock in corporation created under termination statute, finding that stock had value of $1,500 per share was sufficiently supported by the evidence, which included consideration of value of interest of the corporation in reservation mineral lands and in claims against the United States, and nature of the market. Affiliated Ute Citizens of Utah v. U. S., Utah 1972, 92 S.Ct. 1456, 406 U.S. 128, 31 L.Ed.2d 741, rehearing denied 92 S.Ct. 2430, 407 U.S. 916, 32 L.Ed.2d 692, rehearing denied 92 S.Ct. 2478, 408 U.S. 931, 33 L.Ed.2d 345.

§ 78cc. Validity of contracts

Waiver provisions

(a) Any condition, stipulation, or provision binding any person to waive compliance with any provision of this chapter or of any rule or regulation thereunder, or of any rule of an exchange required thereby shall be void.

Contract provisions in violation of chapter

(b) Every contract made in violation of any provision of this chapter or of any rule or regulation thereunder, and every contract (including any contract for listing a security on an exchange) heretofore or hereafter made, the performance of which involves the violation of, or the continuance of any relationship or practice in violation of, any provision of this chapter or any rule or regulation thereunder, shall be void (1) as regards the rights of any person who, in violation of any such provision, rule, or regulation, shall have made or engaged in the performance of any such contract, and (2) as regards the rights of any person who, not being a party to such contract, shall have acquired any right thereunder with actual knowledge of the facts by reason of which the making or performance of such contract was in violation of any such provision, rule, or regulation: *Provided*, (A) That no contract shall be void by reason of this subsection because of any violation of any rule or regulation prescribed pursuant to paragraph (2) or (3) of subsection (c) of section 78o of this title, and (B) that no contract shall be deemed to be void by reason of this subsection in any action maintained in reliance upon this subsection, by any person to or for whom any broker or dealer sells, or from or for whom any broker or dealer purchases, a security in violation of any rule or regulation prescribed pursuant to paragraph (1) of subsection (c) of section 78o of this title, unless such action is brought within one year after the

discovery that such sale or purchase involves such violation and within three years after such violation.

Validity of loans, extensions of credit, and creation of liens; actual knowledge of violation

(c) Nothing in this chapter shall be construed (1) to affect the validity of any loan or extension of credit (or any extension or renewal thereof) made or of any lien created prior or subsequent to the enactment of this chapter, unless at the time of the making of such loan or extension of credit (or extension or renewal thereof) or the creating of such lien, the person making such loan or extension of credit (or extension or renewal thereof) or acquiring such lien shall have actual knowledge of facts by reason of which the making of such loan or extension of credit (or extension or renewal thereof) or the acquisition of such lien is a violation of the provisions of this chapter or any rule or regulation thereunder, or (2) to afford a defense to the collection of any debt or obligation or the enforcement of any lien by any person who shall have acquired such debt, obligation, or lien in good faith for value and without actual knowledge of the violation of any provision of this chapter or any rule or regulation thereunder affecting the legality of such debt, obligation, or lien.

June 6, 1934, c. 404, Title I, § 29, 48 Stat. 903; June 25, 1938, c. 677, § 3, 52 Stat. 1076.

Historical Note

References in Text. This chapter, referred to in subsecs. (a), (b) and (c), in the original read "this title". See References in Text note under section 78a of this title.

1938 Amendment. Subsec. (b). Act June 25, 1938 added the proviso clause.

Library References

Securities Regulation ⟹123.

C.J.S. Securities Regulation § 95.

Notes of Decisions

I. GENERALLY 1–40
II. VALIDITY OF CONTRACTS 41–56

This section of the FEDERAL REGISTER contains notices to the public of the proposed issuance of rules and regulations. The purpose of these notices is to give interested persons an opportunity to participate in the rule making prior to the adoption of the final rules.

[7535-01-M]

NATIONAL CREDIT UNION ADMINISTRATION

[12 CFR Part 703]

INVESTMENTS AND DEPOSITS

Investment Activities of Federal Credit Unions

AGENCY: National Credit Union Administration.

ACTION: Proposed rule.

SUMMARY: The purpose of this proposed rule is to restrict Federal credit union involvement in certain investment activities which the Administration believes are unauthorized or otherwise unsafe and unsound. The rule is necessary in order to avoid recurrence of recent incidents involving substantial losses to Federal credit unions.

DATES: Comments must be received on or before December 15, 1978.

ADDRESS: Send comments to Robert S. Monheit, Senior Attorney, Office of General Counsel, National Credit Union Administration, Room 4202, 2025 M Street NW., Washington, D.C. 20456.

FOR FURTHER INFORMATION CONTACT:

Robert F. Schafer, Office of Examination and Insurance, at the above address. Telephone: 202-254-8760.

SUPPLEMENTAL INFORMATION:

1. *Caution*—During the comment period and until a final regulation is published, Federal credit unions should refrain from engaging in the activities described below.

2. *Background*—Section 107(7) of the Federal Credit Union Act (12 U.S.C. 1757(7)) specifies the investments that Federal credit unions are authorized to make; such investments consist primarily of loans to members and purchases of securities guaranteed by the U.S. Government. In recent months the Administration has learned of several instances of Federal credit unions engaging in various transactions involving Government securities for speculative purposes, rather than to meet legitimate investment and liquidity needs. These speculative transactions have included forward placement contracts, futures, repurchase agreements and reverse repurchase agreements. In some cases, abuses involving these related transactions have resulted in substantial losses to Federal credit unions, which may cause a reduction or loss of dividends to memebers, and may present a potential loss to the National Credit Union Share Insurance Fund. The purpose of this rule is to prevent further abuses by setting forth restrictions on Federal credit union involvment in these activities. This purpose would be accomplished by an amendment to Part 703 of the National Credit Union Administration's Rules and Regulations—"Investments and Deposits." Subsection 703.3(b)(1) has been included to provide that Federal credit unions may purchase and sell securities only when the purchase or sale is to be completed within five business days after the agreement is made. Essentially, this rule would provide that when exercising their investment powers, Federal credit unions shoud engage only in immediate cash settlement transactions.

3. *Forward Placement Contracts (Forwards)*—Forward placement contracts (also known as delayed delivery or future delivery contracts) are contracts to purchase or sell a security at a future date. Forwards were developed by the mortgage industry to facilitate the sale of mortgage-backed securities. As it was originally conceived, an institution that intended to package a pool of mortgages and issue a mortgage-backed security would contract with another party to purchase the security at a future date.

The practice of delivery securities in the future is necessary because of the time required to originate and process the mortgage loans. Generally it takes between 60 to 120 days to package a mortgage-backed security.

The Administration believes that a forwards market to help facilitate the packaging of mortgage-backed securities is a useful vehicle in providing mortgage financing. However, in recent years, the forwards market has been subjected to numerous abuses by brokers and dealers. These firms and/or individuals have contracted with Federal credit unions for forwards which far exceed the time period necessary to develop a mortgage-backed security. Additionally, brokers and dealers have encouraged credit unions to engage in forwards which exceed the credit union's ability to purchase the underlying security on the settlement date. As a result, Federal credit unions, relying on the expertise of their brokers and dealers, have speculated in a very volatile market.

The Administration believes that some brokers and dealers are not using forwards as they were originally intended, but rather as a means of increasing their own profits and commissions at the expense of their customers.

At the present time the investment authority of Federal credit unions in marketable securities is virtually limited to U.S. government and agency securities. Brokers and dealers dealing exclusively in government securities are exempt from the filing and other requirements of the Securities and Exchange Act of 1934 and the self-regulatory proscriptions of the National Association of Securities Dealers (NASD). Additionally, it appears that brokerage firms which deal in government securities have taken little or no action to police their members.

The Administration cannot foresee when and if the abuses in the forwards market will be corrected. Therefore, the Administration proposes to prohibit Federal credit unions from engaging in the two types of forwards because the transactions are either not authorized under the Act or constitute unsafe and unsound practices as explained below.

a. *Standby Commitment.*—A standby commitment (also known as a standby or optional delivery contract) is an agreement for the sale of a security at a future date whereby the buyer is required to accept delivery of the security at the option of the seller. As consideration for the option, the seller usually pays a negotiated commitment fee to the buyer so that he will "standby" to accept delivery. The commitment fee is paid when the parties enter into the contract and is sometimes called "up front money." The fee is nonrefundable to the seller and is realized by the buyer as income even if the securities are not delivered.

The Administration believes that in a standby commitment one party purchases an option to sell and deliver the securities at a future date. The other party creates the option by agreeing to "standby" to purchase the securities if the first party elects to sell. Thus, the investment powers of Federal credit unions (see, 12 U.S.C. 1757(7)) do not include the authority to purchase or sell such an option. This conclusion is specifically set forth at § 703.3(b)(2), which provides that Federal credit unions may not enter into standby commitments to purchase or sell securities.

b. *Cash Forward Agreement.*—A cash forward agreement (also known as a mandatory delivery contract) is an agreement to purchase or sell a security at a future date which requires mandatory delivery and acceptance.

The Administration believes that in a properly controlled environment, where suitability standards have been developed and enforced, Federal credit union involvement in cash forward agreements might be a legitimate investment tool. The recurrence of abuses in the presently unregulated government securities market, however, causes the Administration to view Federal credit union involvement in cash forward agreements as an unsafe and unsound investment activity. This conclusion is stated in § 703.3(b)(3) of the rule, which provides that Federal credit unions may not enter into cash forward agreements.

The Administration would reconsider this position should the investment industry develop an adequate self-reg-

ulatory structure with respect to dealers of U.S. Government and agency securities.

4. *Reverse Repurchase Agreement (Reverse Repo)*.—A reverse repurchase agreement is an agreement whereby a Federal credit union sells securities to a purchaser and repurchases the same securities from the purchaser at an agreed upon future date. The Federal credit union pays interest on the funds received for the sale of the securities at an agreed upon rate and usually continues to receive income from the dividends or interest borne by the securities during the period when they are "sold" to the purchaser. The Administration believes the reverse repurchase agreement is a borrowing activity by the credit union. As such, it is permissible subject to the limitations of section 107(9) of the Federal Credit Union Act (12 U.S.C. 1757(9)) that a Federal credit union may not borrow in excess of 50 percent of its paid in and unimpaired capital and surplus.

Some Federal credit unions have borrowed funds via reverse repos and used those funds to purchase new marketable securities. In some cases, the new securities have been used to borrow additional funds, which are also used to purchase new marketable securities. Credit unions engaging in this type of pyramiding are speculating that either:

a. The market price of the new marketable securities will increase and a profit will result from the sale of those securities, or

b. The market price will remain stable and increased income will result from the arbitrage, the difference between interest paid on the borrowed funds and the dividend or interest earned on the securities.

However, if the market price declines and credit unions are forced to sell the securities, losses will be incurred.

The use of reverse repurchase agreements for this and like speculative purposes is not properly incidental to the Federal credit union's borrowing authority, investment authority or any other express power, and is considered an unsafe and unsound practice. These conclusions are reflected in § 703.3(b)(6). However, Federal credit unions would not be prohibited from using reverse repurchase agreements to meet ordinary and unexpected liquidity needs such as temporary share withdrawals or loan demands.

5. *Repurchase Agreements*.—Having determined that reverse repurchase agreements were loans to credit unions, the Administration was required to consider the converse of that transaction; the repurchase agreement. The Administration recognizes that the repurchase agreement is a constructive investment technique which enables a credit union to invest its excess funds, particularly on an overnight or weekend basis. However, when such a transaction constitutes a loan, the credit union is then limited by seciton 107(5) of the Federal Credit Union Act (12 U.S.C. 1757(5)) to dealing with members, other credit unions, or credit union organizations. For a Federal credit union to engage in a repurchase agreement with organizations other than those cited in section 107(5), all the essential elements of a sale of the security must be present. The distinction between the loan-type and investment-type repurchase agreement is set forth in § 703.3(a)(4). The limitations on each type of repurchase agreement is set forth in § 703.3(b)(4) and 703.3(b)(5).

In addition to the legality of the transaction, the Administration has also considered the safety and soundness of the repurchase agreement. The major element of risk in the investment-type transaction would be the loss of dominion over the security. Therefore, the Administration proposes to authorize the investment-type repurchase agreement provided the Federal credit union takes possession of the securities or there is a segregation of the securities from the assets of the vendor. This requirement is contained in § 703.3(a)(4)(i)(l).

6. *Futures*.—A future is a standardized contract for future delivery of commodities, including certain government securities sold on designed commodities and exchange markets, e.g., the Chicago Board of Trade. Unless the contract represents a bonafide hedging contract incident to the assembly of a pool of mortgages for sale in the secondary market, the transac-

tion represents an investment which is separate and apart from the underlying security. Therefore, Federal credit unions may not purchase a future since it is an investment not authorized by section 107(7) of the Federal Credit Union Act (12 U.S.C. 1757(7)). This determination is reflected in § 703.3(b)(7).

7. *Outstanding Commitments.*—Numerous Federal credit unions are already committed to the transactions noted above. Until a final determination is made on the permissibility of such transactions, Federal credit unions are required to comply with the following guidelines and accounting procedures:

a. Standby commitments to purchase securities.

i. The amount of the standby commitment must be shown as a footnote or memorandum entry on the credit union's Statement of Financial Condition for each month the commitment is outstanding. The footnote will reflect both the agreed upon purchase price and the market price on the statement date.

ii. The commitment fee may not be recognized as income until the date of settlement. Thus when the fee is received, it shall be recorded in account No. 889, Other Deferred Income. On the settlement date the fee will be recorded in account No. 440, Other Non-Operating Income (Expense).

iii. When purchased, the underlying security shall be recorded at the lower of cost or market. Losses, if any, shall be shown in account No. 420, Gain (Loss) on Investments.

b. Standby commitments to sell securities.

i. The amount of the standby must be shown as a footnote or memorandum entry on the credit union's Statement of Financial Condition for each month the commitment is outstanding.

ii. The commitment fee will be recognized as an expense on the date of commitment. The fee will be recorded in account No. 440, Other Non-Operating Income (Expense).

iii. The gain or loss on the sale of the underlying security will not be recognized until the settlement date.

c. Cash forward agreement to purchase securities.

i. The amount of the cash forward agreement must be shown as a footnote or memorandum entry on the credit union's Statement of Financial Condition for each month the commitment is outstanding. The footnote will reflect the agreed upon purchase price and the market price on the statement date.

ii. When purchased, the underlying security shall be recorded at the lower of cost or market. Losses, if any shall be shown in account No. 420, Gain (Loss) on Investments.

d. Cash forward agreements to sell securities

i. The amount of the cash forward agreement must be shown as a footnote or memorandum entry on the credit union's Statement of Financial Condition for each month the commitment is outstanding.

ii. The gain or loss on the sale of the underlying security will not be recognized until the settlement date.

Examples of accounting entries for standby commitments to purchase and sell securities can be found in Appendixes A and B respectively. Accounting entries for cash forward agreements are the same as those for standbys, except for the commitment fee.

e. Investment-type repurchase agreements.

i. The security purchased will be recorded at cost in the appropriate investment account (series 740).

ii. The credit union's Statement of Financial Condition will be footnoted to reflect the amount of securities which are subject to resale and the date of resale.

iii. Gains and losses on the sale of the securities sold on the settlement date will be reflected in account No. 420, Gain (Loss) on Investments.

iv. The interest or dividend received on the securities during the period of ownership must be reflected in account No. 121, Income on Investments.

An example of the accounting entries for investment-type repurchase agreements can be found in Appendix C.

f. Loan-type repurchase agreements.

i. Loan-type repurchase agreements to members must be made in accordance with and within the limitations

established in the Federal Credit Union Act, the Federal Credit Union Bylaws, the National Credit Union Administration Rules and Regulations, and policies established by the board of directors. These requirements include but are not limited to a maximum loan limit of 10 percentum of unimpaired capital and surplus to one member, the receipt of a properly supported loan application, approval of the loan by the credit committee, and execution of a note supported by documentation of the collateral. Account No. 705, Loans Subject to Repurchase Agreements, will be used to record these loans.

ii. Loan-type repurchase agreements to other credit unions must conform with limitations contained in section 107(7)(C) of the Act and Part 703.2 of the NCUA Rules and Regulations. These loans will be recorded in account No. 747, Loans to Other Credit Unions.

iii. Loan-type repurchase agreements to approved credit union organizations must be in compliance with section 107(5)(D) of the Act and NCUA Rules and Regulations.

iv. The securities used as collateral for the loan-type repurchase agreement will be identified in a footnote or memorandum entry on the credit union's Statement of Financial Condition for each month the repurchase agreement is outstanding. The footnote will reflect the market price of the securities on the statement date.

v. Income received from loans to members will be recorded in account No. 111, Interest on Loans. Income received from loans to credit union organizations and loans to other credit unions will be recorded in account No. 121, Income from Investments.

An example of the accounting entries for loan-type repurchase agreements can be found in Appendix D.

g. Reverse repurchase agreements.

i. Funds received from reverse repos will be recorded as borrowed funds in account No. 812, Notes Payable—Other.

ii. The securities used as collateral for the reverse repos will be identified in a footnote or memorandum entry on the credit union's Statement of Financial Condition for each month the reverse repo is outstanding. The footnote will reflect both the book value and the market price on the statement date.

iii. Interest paid on reverse repos will be recorded in account No. 340, Interest on Borrowed Money.

An example of the accounting entries for permissible reverse repurchase agreements can be found in Appendix E.

APPENDIX A.—ACCOUNTING ENTRIES FOR A STANDBY COMMITMENT TO PURCHASE A SECURITY

Assume that an FCU entered into a Standby Commitment to purchase at 93 a Federal Agency Security with a par value of $1 million. A one percent of par commitment fee is paid to the FCU and on the settlement date, the market value is 93.

ENTRIES

Date of commitment:

The records of the Federal credit union are footnoted.

Date commitment fee is received:

Dr. cash (731)—10,000.

Cr. other deferred income (889)—10,000.

To record receipt of commitment fee.

Date of settlement (securities not delivered):

Dr. other deferred income (889)—10,000.

Cr. other nonoperating income (expense) (44)—10,000.

To recognize income from Standby Commitment.

Date of settlement (securities delivered):

Dr. Federal agency securities (742)—930,000.

Dr. gain (loss) of investments (420)—20,000.

Cr. cash (731)—950,000.

To record purchase of security at lower of cost or market.

Dr. other deferred income (889)—10,000.

Cr. other nonoperating income (expense) (440)—10,000.

To recognize income from standby commitment.

Footnote is removed from records.

APPENDIX B.—ACCOUNTING ENTRIES FOR A STANDBY COMMITMENT TO SELL A SECURITY

Assume that an FCU entered into a Standby Commitment to sell a Federal Agency Security which has a par value of $1 million and is recorded on the credit union's books at 97. The agreed upon sale price is 98 and the commitment fee is 1½ percent.

ENTRIES

Date of commitment (and fee payment):

The records of the Federal credit union are footnoted.

Dr. other nonoperating income (expense) (440)—15,000.

Cr. cash (731)—15,000.

To record payment of commitment fee.

Date of settlement (securities delivered):

Dr. cash (731)—980,000.

Cr. Federal agency securities (742)—970,000.

Cr. gain (loss) on investments (420)—10,000.

To record sale of security.

Footnote is removed from records.

APPENDIX C.—ACCOUNTING ENTRIES FOR AN INVESTMENT-TYPE REPURCHASE AGREEMENT

Assume that FCU "A" enters into a repurchase agreement with its broker on April 15 whereby it purchases a $1 million Federal Agency Security at par. It also agrees to resell to the broker a similar type security on April 18. On April 18, the FCU decides to resell the same security, but the fair market value of the security is $99\frac{31}{32}$.

ENTRIES

April 15:

Dr. Federal agency securities (742)—1,000,000.

Cr. cash (731)—1,000,000.

To record purchase of security.

The records of the Federal credit union are footnoted.

April 18:

Dr. cash (731)—999,688.

Dr. gain (loss) on investments (420)—312.

Cr. Federal agency securities (742)—1,000,000.

To record sale of securities.

Dr. cash (731)—667.

Cr. income from investments (121)—667.

To record income from investment for three days.

Footnote is removed from records.

APPENDIX D.—ACCOUNTING ENTRIES FOR A LOAN-TYPE REPURCHASE AGREEMENT

Assume FCU "A" enters into a Repurchase Agreement with FCU "B" whereby "A" lends $1 million to "B" on February 1 and receives as collateral a $1 million Federal Agency security valued at par. FCU "B" agrees to repay the loan on August 1. The interest rate is 6 percent. The value of the security on June 30 is 99.

ENTRIES ON THE BOOKS OF FCU "A"

February 1:

Dr. loans to other credit unions (747)—1,000,000.

Cr. cash (731)—1,000,000.

To record loan.

The records of the Federal credit union are footnoted.

August 1:

Dr. cash (731)—1,030,000.

Cr. loans to other credit unions (747)—1,000,000.

Cr. income from investment (121)—30,000.

To record repayment of loan with interest.

Footnote is removed from records.

Entries for FCU "B" are contained in Appendix E.

APPENDIX E.—ACCOUNTING ENTRIES FOR A PERMISSIBLE REVERSE REPURCHASE AGREEMENT

Referring to Appendix D, FCU "B" would record the transaction as a Reverse Repurchase Agreement. In addition to the information given in that example, assume also that FCU "B" is unable to repay the loan from available funds on settlement date. FCU "B" chooses to sell the underlying security at its fair market value of 99½. The security is booked at par.

ENTRIES ON THE BOOKS OF FCU "B"

February 1:

Dr. cash (731)—1,000,000.

Cr. notes payable—other (812)—1,000,000.

To record the reverse repo as borrowed funds.

The records of the Federal credit union are footnoted.

August 1:

Dr. cash (731)—995,000.

Dr. gain (loss) on investments (420)—5,000.

Cr. Federal agency securities (742)—1,000,000.

To record sales of the underlying security recognizing a $5,000 loss.

Dr. notes payable (812)—1,000,000.

Dr. interest on Borrowed money (340)—30,000.

Cr. cash (731)—1,030,000.

To record payment of notes payable and interest due.

Footnote is removed from records.

Accordingly, 12 CFR Part 703 is amended by adding a new section as set forth below.

LAWRENCE CONNELL,
Administrator.

OCTOBER 11, 1978.

AUTHORITY: Sec. 107, 91 Stat. 49 (12 U.S.C. 1757), Sec. 120, 73 Stat. 635 (12 U.S.C. 1766) and Sec. 209, 84 Stat. 1104 (12 U.S.C. 1789).

703.3 Investment activities.

(a) Definitions.

(1) "Standby commitment" means an agreement to purchase or sell a security at a future date, whereby the buyer is required to accept delivery of the security at the option of the seller.

(2) "Cash forward Agreement" means an agreement to purchase or sell a security at a future date more than five days after the agreement is made and that requires mandatory delivery and acceptance.

(3) "Reverse repurchase agreement" means an agreement whereby a Federal credit union enters into an understanding to sell securities to a purchaser and to repurchase the same securities from that purchaser at a future date, irrespective of the amount of consideration paid by the Federal credit union or the purchaser.

(4) "Repurchase agreement" means an agreement whereby a Federal credit union enters into an understanding to buy securities from a vendor and to resell securities at a future date. Repurchase agreements may be of two types:

(i) "Investment-type repurchase agreement" means a repurchase that contains the essential elements of a sale of a security, namely:

(*a*) The Federal credit union purchasing the securities must take physical possession of the securities or must receive a custodial or safekeeping receipt from a bank or other financial institution evidencing that the securities have been segregated from the general assets of the vendor.

(*b*) The Federal credit union must not be required to deliver the identical securities in the event of repurchase.

(*c*) The Federal credit union must assume the risk of market fluctuations in the value of the securities it has purchased.

(*d*) The Federal credit union must receive the coupon or stated interest rate or dividend on the securities purchased for the time period owned.

(ii) "Loan-type repurchase agreement" means any repurchase agreement that does not qualify as an investment-type repurchase agreement.

(5) "Future" means a standardized contract for the future delivery of commodities, including certain government securities, sold on designated commodities exchanges.

(b) Limitations.

(1) Federal credit unions may purchase or sell securities authorized by 12 U.S.C. 1757(7) only when the purchase or sale is to be completed within five business days after the agreement is made.

(2) Federal credit unions may not enter into standby commitments to purchase or sell securities.

(3) Federal credit unions may not enter into cash forward agreements to purchase or sell securities.

(4) Federal credit unions may not enter into investment-type repurchase agreements unless all the conditions cited in § 703.3(a)(4)(i) are met. Any repurchase agreements that do not meet such requirements constitute loan-type repurchase agreements subject to the limitations of § 703.3(b)(5).

(5) Federal credit unions may enter into loan-type repurchase agreements only with their own members, other credit unions or approved credit union organizations. Loan-type repurchase agreements represent lending and are subject to the limitations of 12 U.S.C. 1757(5).

(6) Federal credit unions may not enter into reverse repurchase agreements with the intent of using the funds received to purchase securities authorized under 12 U.S.C. 1557(7)(B), (D), (E), (F), (I) or 12 U.S.C. 1757(8). Reverse repurchase agreements represent borrowing and are subject to the limitations of 12 U.S.C. 1757(9).

(7) Federal credit unions may not buy or sell a future contract except when used as a hedging contract incident to the assembly of a pool of mortgages for sale in the secondary market.

[FR Doc. 78-29213 Filed 10-16-78; 8:45 am]

NATIONAL CREDIT UNION ADMINISTRATION

12 CFR Part 703

Investments and Deposits

AGENCY: National Credit Union Administration.

ACTION: Final rule.

SUMMARY: This rule amends Part 703 by adding a new section 703.3 that restricts the investment activities of Federal credit unions based upon the Administration's determination that certain activities are unauthorized or otherwise unsafe or unsound. The rule prohibits the use of standby commitments, adjusted trading and short sales, sets forth limitations on the purchase and sale of securities, cash forwards, repurchase transactions, reverse repurchase transactions, and future contracts. The purpose of the rule is to prohibit or limit certain types of investment activities that have resulted in substantial financial losses to Federal credit unions that may cause a reduction or loss of dividends to members or otherwise jeopardize the interests of members and may present a potential loss to the National Credit Union Share Insurance Fund.

EFFECTIVE DATE: July 20, 1979.

ADDRESS: National Credit Union Administration, 2025 M Street, N.W., Washington, D.C., 20456.

FOR FURTHER INFORMATION CONTACT: Robert F. Schafer, Office of Examination and Insurance, or Frederick S. Lipton, Office of General Counsel, at the above address. Telephone: (202) 254-8760 (Mr. Schafer) or (202) 632-4870 (Mr. Lipton).

SUPPLEMENTARY INFORMATION: On October 17, 1978, the Administration published a proposed regulation (43 FR 47731) that would restrict Federal credit union involvement in certain investment activities that the Administration believes are unauthorized or otherwise unsafe and unsound. Public comment was invited, to be received on or before December 15, 1978. In response to several comments received, the official comment period was extended to March 15, 1979. Upon review of all comments received and after a thorough reconsideration of the proposed regulation by the Administration, certain changes, as set forth below, have been made. Analysis of Changes:

1. Definitions

Several definitions have been added to those contained in the proposed regulations. Terms such as "trade date", "settlement date" and "maturity date" have been added for clarification purposes. Other terms such as "adjusted trading" and "short sales" have been added for substantive reasons and are discussed below under appropriate headings. For the most part, these definitions agree with those contained in the Analysis and Report on Alternative Approaches to Regulating the Trading of GNMA Securities released by the Government National Mortgage Association (November 7, 1978).

The term "agreement" as used in conjunction with repurchase and reverse repurchase activities, defined in sections 703.3(a)(4) and (5), has been replaced by the term "transaction" since these activities represent financial transactions and the term more accurately describes these activities when they involve borrowing and lending by Federal credit unions. Several commenters suggested that the definitions of repurchase and reverse repurchase transactions are written from the standpoint of a broker or other vendor of securities. The Administration agrees that the above definition describes a transaction with a Federal credit union from the point of view of the party dealing with the credit union. However, for several reasons the Administration has in substance retained the definitions set out in the proposed regulation. Repo's and reverse

repo's are often referred to by certain Government agencies and securities brokers in the same manner as set out in the proposed regulation. Further, the Administration has previously issued accounting procedures to all Federal credit unions based upon the terminology set out in the proposed regulation. For these reasons the Administration believes that it would be less confusing for Federal credit unions to retain the definitions of a repurchase and reverse repurchase transaction set out in the proposed regulation.

2. 5-Day Settlement Date

Many commenters objected to the limitation in the proposed regulation that Federal credit unions purchase or sell securities only when the purchase or sale is to be completed within 5 business days after the agreement of purchase or sale is made. The proposed limitation would have generally restricted investments to immediate cash settlement transactions. Ordinarily, however, a settlement period, i.e., a delivery period of up to 30 days, is required in order to facilitate the purchase or sale of U.S. Government and Federal agency securities. Therefore, the 5 business days requirement has been deleted from section 703.3(b)(1) of the final rule, which now provides that the security is to be delivered within 30 days from the trade date.

Some commenters suggested that certain types of securities, e.g., Small Business Administration guaranteed loans, be exempted from any requirement for a limited settlement period due to the irregular issuance or guarantee of these securities. The Administration believes that a 30 day delivery period encompasses the time limits for settlement when such securities are obtained on a "when issued" basis. However, for those securities that may not be capable of settlement within the 30 day period, the final regulation relaxes the originally proposed prohibition on cash forward agreements as discussed below under Cash Forward Agreements.

3. Market Price

"Market price" is defined in section 703.3(a)(13) as the last established price at which a security is sold. Section 703.3(b)(10) of the final rule provides all cash transactions under section 703.3(b)(1) and all cash forward transactions under section 703.3(b)(3) must be at the market price. In the case of an immediate cash purchase or sale of a security, there is no legitimate reason for a Federal credit union to pay a purchase price either above or below the market price. The purchase or sale of a security above its market price is in most cases due to an attempt to hide or defer investment losses, practices not in accord with the "full and fair disclosure" requirement of section 702.3 of the rules and regulations or the Accounting Principles and Standards for Federal Credit Unions. A vendor ordinarily expects a Federal credit union to enter into an offsetting sale or trade in return for selling it a security below market price. Such transactions usually result in a loss for the Federal credit union. Further, the sale of a security below its market price by a Federal credit union results in an immediate loss. Thus, the Administration considers that it is an unsafe and unsound practice for a Federal credit union to enter into a cash transaction for the immediate purchase or sale of a security either above or below its market price.

The purchase or sale of a security off the market price by a cash forward agreement is unsafe and unsound for the same reasons as are applicable to an immediate cash purchase. Under the final rule the primary purpose of allowing a cash forward agreement is to provide for the purchase of U.S. Government and Federal agency securities. Such purchases when made at the market price avoid speculation and potential losses on the part of a Federal credit union. In addition, the standard of requiring these trades to be at market price is followed by other financial regulatory agencies.

As was suggested by one commenter, the final rule also requires that the purchase price of a security obtained

under a repurchase transaction must be at the market price. This change, contained in section 703.3(b)(4), is also adopted for the same reasons that the purchase price of a security obtained by a cash purchase or a cash forward agreement is required to be at the market price.

4. Forward Placement Contracts

Under the proposed regulation, Federal credit unions were prohibited from engaging in both types of forward placement contracts, *i.e.*, standby commitments and cash forward agreements. The final rule also prohibits Federal credit unions from engaging in standby commitments, but permits the purchase and sale of authorized securities by means of a cash forward agreement, as explained below.

a. Standby Commitments

Section 703.3(b)(2) of the proposed regulation contained a general ban on Federal credit unions engaging in standby commitments to purchase or sell securities. Some commenters suggested that Federal credit unions should be permitted to engage in buying and selling standby commitments for authorized securities as a means of hedging against potential losses incurred in the making of real estate loans. The Administration believes that the informal and unorganized nature of the market in standby commitments argues against its use as a hedging device by Federal credit unions.

Since the Administration does not believe that hedging by means of buying and selling standby commitments for authorized securities is necessary to make real estate loans, the final rule contains the same general ban on standby commitments. However, it does not prohibit a Federal credit union from selling its real estate loans by use of a standby commitment in order to facilitate the making of such loans. This has been accomplished by defining the term "security" as not to include loans to members or residential real estate loans authorized under subsections 701.21–6 and 701.21–8 of Part 701 of the National Credit Union Administration rules and regulations. Such activity would be incidental to the exercise of a Federal credit union's real estate lending authority.

b. Cash Forward Agreements (Forwards)

Some commenters suggested that Federal credit unions be allowed to participate in forwards for the purchase or sale of securities. Comments were also received stating that forwards play an important part in the sale of certain Government securities representing pools of mortgages secured by real estate. Other commenters supported the position of the Administration set out in the proposed regulation that numerous abuses can presently be found in the forwards market and that until such abuses are corrected, Federal credit unions should be prohibited from engaging in any forward transactions.

The Administration has determined that Federal credit unions should be permitted to engage in cash forward agreements. As stated above, commenters have noted that cash forward transactions would support the market for Government securities representing pools of mortgages. The Administration believes that a cash forward agreement for a settlement period not exceeding 120 days from the trade date to the settlement date in the case of a purchase of authorized securities will assist in the sale of mortgage loans secured by real estate and will not subject Federal credit unions to an undue or excessive market risk. Additionally, the Administration is cognizant of the steps taken by the securities industry to implement a scheme of self-regulation of brokers and dealers engaged in the purchase or sale of U.S. Government and Federal agency securities. Should the concept of self-regulation not become a reality and abuses continue, the Administration will necessarily be required to reconsider its position in regard to permitting cash forward agreements.

Therefore, under section 703.3(b)(3) of the final rule, a Federal credit union may enter into a cash forward agreement to purchase a security when delivery is to be made up to 120 days from the trade date. When the delivery of the security is to be made beyond the 30 day period

under section 703.3(b)(1) of the final rule, a Federal credit union will be required to prepare a written cash flow projection evidencing its ability to purchase the security. The accounting procedures for such a purchase will be set out in an NCUA Interpretive Ruling and Policy Statement. This Statement will require that in cases where settlement for the purchase of authorized securities is over 30 days, the mark to the lower cost or market accounting procedure must be applied. Thus, those U.S. Government and Federal agency securities such as SBA guaranteed loans, that cannot be settled within 30 days are not prohibited, but rather are subject to the requirements set out in section 703.3(b)(3) of the final rule.

A cash forward agreement to sell a security is not subject to the 120 day limitation, but a Federal credit union cannot enter into such an agreement unless it presently owns the security. As a further safeguard, and as suggested by many commenters, the final rule imposes a requirement that all cash forward agreements must be settled in cash and, thus, may not be extended or "rolled over" into new contracts that would extend the original settlement date.

5. Repurchase Transaction (Repo)

Some commenters suggested that the proposed regulation was unnecessarily restrictive in prohibiting Federal credit unions from entering into loan-type repurchase transactions with financial institutions other than credit unions. The prohibition in the proposed regulation was based upon section 107(5) of the Federal Credit Union Act ("the Act") (12 U.S.C. 1757(5)), which provides, in part, that a Federal credit union may make loans to its members, other credit unions and credit union organizations. In view of this statutory authority, the prohibition against engaging in loan-type repurchase transactions with other financial institutions has been retained in the final rule.

One commenter suggested that the requirements for delivery of a security purchased under an investment-type repurchase agreement could be best accomplished by utilizing the concept of "delivery" under section 8–313 of the Uniform Commercial Code. The Administration agrees. In order to conform to a "delivery" under section 8–313, the requirement of obtaining a confirmation of the purchase of the security has been added to subsection 703.3(a)(4)(A)(i) of the final rule. Section 8–313 implies that this confirmation be in writing, and such a requirement has also been added to the above referenced section of the final rule.

Further, the requirement in the proposed regulation that securities sold under an investment-type repurchase transaction be held by the Federal credit union or in a custodial or safekeeping account in a bank or other financial institution has been changed, the final rule requires that there be a written "bailment for hire contract" with the bank or other financial institution. The proposed regulation, by requiring that a bank or other financial institution hold the securities in a custodial or safekeeping account, imposed a bailment for hire contract by operation of law.

Section 703.2(a)(4) of the proposed rule on repurchase transactions has been revised to require that, in the case of an investment-type repurchase transaction, there must be an unrestricted transfer of ownership of the security by the vendor to the Federal credit union or its agent. The proposed regulation had required that the Federal credit union must assume the risk of market fluctuation and must receive the coupon or stated interest, yield or dividend rate. The requirement for an unrestricted transfer of ownership will encompass both of the proposed requirements. Thus, reference to those requirements were deleted as suggested by one commenter. Under the final rule the essential elements of a permissible purchase of a security from a vendor, rather than those of a prohibited loan to a vendor, will be present.

6. Reverse Repurchase Transactions (Reverse Repo's)

Under a reverse repurchase transaction a Federal credit union obtains the use of funds for a fixed period and pledges securities owned by

it as collateral. Thus, as set out in section 703.3(b)(6) of the proposed regulation, section 703.3(a)(5) of the final rule defines this activity as a borrowing that is subject to the limitations set out in section 107(9) of the Act (12 U.S.C. 1757(9)) that a Federal credit union may not borrow an aggregate amount exceeding 50 percent of its paid-in and unimpaired capital and surplus.

One commenter suggested that a Federal credit union should exercise care in choosing a securities firm with which to enter into a reverse repo. The commenter also correctly pointed out that if a securities firm is insolvent on the date the reverse repo matures, the credit union may not recover its collateral. Since less than the full amount of the collateral is usually loaned to a credit union in a reverse repo, the credit union can experience a substantial loss when that collateral is not returned. An NCUA Interpretive Ruling and Policy Statement, to be issued shortly, will provide guidance for Federal credit unions in dealing with securities firms.

Under the proposed regulation, section 703.3(b)(8), a Federal credit union could not enter into a reverse repo with the intent of using the funds so obtained to purchase securities authorized under sections 107(7)(B), (D), (E), (F), (I) or 107(8) of the Act (12 U.S.C. 1757(7)(B), (D), (E), (F), (I) or 12 U.S.C. 1757(8)). (The proposed regulation did not contain a prohibition on investments authorized under 12 U.S.C. 1757(7)(G) and 1757(7)(H). No comments were received in this regard and the Administration finds no basis for excluding such investments from the restrictions contained in the final regulation. In addition, certain sections referred to in the proposed regulation as investments can be deemed to be deposits, i.e., 12 U.S.C. 1757(7)(D) and 1757(8).)

Several commenters suggested that this prohibition not be adopted. Instead, it was suggested that the regulation permit the investment of the obtained funds in certificates of deposit or approved common trust funds. Most of these commenters expressed the opinion that a prohibition against purchasing securities with funds obtained by means of reverse repurchase agreements would deny Federal credit unions the opportunity to maximize the return on their investments.

The Administration believes that the practice of investing funds borrowed by means of a reverse repurchase transaction in new long term securities that may fluctuate in value without using presently held securities that mature prior to the reverse repo date as collateral for the reverse repurchase agreement, is an unsafe and unsound practice. The final rule maintains the prohibition against such a practice, i.e., investment in new long term securities without adequate short term safeguards. The Administration has determined, however, that the blanket prohibition contained in the proposed regulation can be relaxed without compromising the Administration's position on safe and sound operation. This has been accomplished in the final rule by limiting the amount and maturity of investments purchased with reverse repo funds as explained below.

First, either the investments or deposits made with funds obtained through a reverse repurchase transaction or securities collateralizing that transaction must have a maturity date not later than the settlement date for the reverse repurchase transaction. Second, the amount of funds obtained by means of a reverse repo for investment or deposit purposes is limited to a maximum of 10 percent of the paid-in and unimpaired capital and surplus of the Federal credit union. In other words, under the final regulation, a Federal credit union can borrow funds by means of a reverse repurchase transaction and invest or deposit those funds, up to the 10 percent limitation, in authorized investments or deposits that mature prior to the reverse repo settlement date. Under the proposed regulation, those funds could not have been reinvested in other investments or deposits. Alternatively, under the final regulation, a Federal credit union can borrow funds and make investments that mature after the reverse repo date

provided the securities used as collateral on the reverse repo mature prior to the settlement date of the reverse repo. The final regulation does not include investments in service organizations under section 107(7)(I) of the Act. This has been done because those investments are not readily marketable, due to uncertainty as to maturity date, if any, and because the investment in such organizations is designed for capitalization rather than return on investment.

7. Adjusted Trading

The Administration has noted that some Federal credit unions have engaged in certain practices in order to hide or defer losses that have resulted mostly from their overcommitments to purchase securities. Such practices are known as "adjusted trading" or "overtrading" and violate section 702.3 of the rules and regulations, in that the Federal credit union engaged in such practices does not provide "full and fair disclosure" of its financial condition to its members, its creditors, or the Administration. Additionally, adjusted trading violates the Accounting Principles and Standards for Federal Credit Unions in that losses are not recorded during the accounting period when they are incurred. Accordingly, the final rule in the new section 703.3(b)(8) prohibits Federal credit unions from engaging in adjusted trading. Descriptions of various types of adjusted trading will be contained in an NCUA Interpretive Ruling and Policy Statement.

8. Short Sale

The final regulation contains a prohibition against a Federal credit union engaging in a short sale in section 703.3(b)(9). A short sale is defined in section 703.3(a)(12) as the sale of a security not owned by the seller. A short sale requires the seller to borrow or purchase securities in order to make delivery to the purchaser. The Federal Credit Union Act does not provide the authority for Federal credit unions to sell securities that are not presently owned by them. In addition, engaging in short sales constitutes an unsafe and unsound practice.

9. Accounting Procedures

Numerous comments were received regarding the accounting procedures discussed in the preamble to the proposed regulation. These comments and accounting procedures will be addressed in an NCUA Interpretive Ruling und Policy Statement.

10. Futures Markets

The proposed regulation limited Federal credit union participation in a futures market to the purchase or sale of a futures contract as a hedging device incident to the assembly of a pool of mortgages for sale in the secondary market. The Administration will issue a proposed regulation on that subject. Until that regulation is published in final form, Federal credit unions may not participate in any futures trading.

11. Application to Federally Insured Credit Unions

This Administration has received several comments requesting that the final regulation on investment activities of Federal credit unions also be made applicable to federally insured State chartered credit unions. The Administration has chosen not to take such action at this time. It has been determined that in order to do so, notice of such action would be required in proposed form. Due to the fact that the proposed regulation made no mention of possible expansion of the applicability of the final regulation, federally insured State chartered credit unions and their respective supervisory agencies were not provided with the necessary opportunity for comment. The Administration intends, instead, to rely on the individual state supervisory agencies to appropriately regulate the institutions that fall within their jurisdiction in light of the investment authority contained in state credit union statutes. Where it is determined that necessary regulatory or corrective action is not being pursued at the State level, the Administration will, on a case by case basis, exercise its administrative action authority. The Administration will, however, as the need arises, review and re-evaluate its position on this issue.

12. Effective Date

Some commenters expressed concern over whether the final rule would be applicable to the transactions entered into before its effective date. The final rule is not retroactive and, therefore, does not affect transactions entered into prior to the effective date.

Federal credit unions that, prior to the effective date of the final rule, have made commitments to purchase securities or have borrowed funds via reverse repurchase transactions should begin to wind-down those activities in a safe and orderly manner.

As a general rule, those Federal credit unions that have previously entered into a suitable commitment to purchase a security even if the commitment is not authorized under the final rule, should meet that commitment. Also, those Federal credit unions that have engaged in reverse repurchase transactions to purchase securities and are unable to repay the borrowed funds may extend the terms of those borrowings, provided, however, that the amount of the borrowings does not exceed the limitations of section 107(9) of the Federal Credit Union Act (12 U.S.C. 1757(9)) and that future borrowings do not violate the new section 703.3(b)(6) of the rules and regulations.

If as a result of their investment activities Federal credit unions have impaired either the liquidity or earnings, they should contact their NCUA Regional Office for guidance in resolving their problems.

Because the final rule relates to the safety and soundness of Federal credit unions and these institutions are insured by this Administration, it is in the public interest that the final rule become effective without delay. Further, the final rule has no retroactive effect; thus, an immediate effective date will not impose a financial burden on Federal credit unions. Therefore, the Administration finds that publication of the final rule for the 30 days specified in 5 U.S.C. 553(d) prior to its effective date is unnecessary, and the final rule shall become effective July 20, 1979.

Accordingly, 12 C.F.R. 703 is amended by adding a new § 703.3 as set forth below.

Lawrence Connell,

Chairman.

July 17, 1979.

Authority: Sec. 107, 91 Stat. 49 (12 U.S.C. 1757), Sec. 120, 73 Stat. 635 (12 U.S.C. 1766) and Sec. 209, 84 Stat. 1104 (12 U.S.C. 1789).

§ 703.3 Investment activities.

(a) *Definitions.* (1) "Security" means any investment or deposit authorized for a Federal credit union pursuant to sections 107(7) and 107(8) of the Act. For the purpose of this section, the definition of a security shall not mean loans to members or loans authorized under §§ 701.21-6 and 701.21-8 of the rules and regulations.

(2) "Standby commitment" means an agreement to purchase or sell a security at a future date, whereby the buyer is required to accept delivery of the security at the option of the seller.

(3) "Cash forward agreement" means an agreement to purchase or sell a security, at a future date, that requires mandatory delivery and acceptance. The contract for the purchase or sale of a security for which delivery of the security is made in excess of thirty (30) days but not exceeding one hundred and twenty (120) days from the trade date shall be considered to be a cash forward agreement.

(4) "Repurchase transaction" means a transaction in which a Federal credit union agrees to purchase a security from a vendor and to resell a security to that vendor at a later date. A repurchase transaction may be of two types:

(i) "Investment-type repurchase transaction" means a repurchase transaction where:

(A) The Federal credit union purchasing the security takes physical possession of the security, or receives written confirmation of the purchase and a custodial or safekeeping receipt from a third party bank or other financial institution under a written bailment for hire contract identifying a specific security in its possession as owned by the Federal credit union;

(B) There is no restriction on the transfer of the security purchased by the Federal credit union; and

(C) The Federal credit union is not required to deliver the identical security to the vendor upon resale.

(ii) "Loan-type repurchase

transaction" means any repurchase transaction that does not qualify as an investment type repurchase transaction. A loan type repurchase transaction represents a lending transaction and is subject to the limitations of section 107(5) of the Act.

(5) "Reverse repurchase transaction" means a transaction whereby a Federal credit union agrees to sell a security to a purchaser and to repurchase the same security from that purchaser at a future date irrespective of the amount of consideration paid by the Federal credit union or the purchaser. A reverse repurchase transaction represents a borrowing transaction and is subject to the limitations of section 107(9) of the Act.

(6) "Futures contract" means a standardized contract for the future delivery of commodities, including certain government securities, sold on designated commodities exchanges.

(7) "Trade date" means the date a Federal credit union originally agreed, whether verbally or in writing, to enter into the purchase or sale of a security with a vendor.

(8) "Settlement date" means the date originally agreed to by a Federal credit union and a vendor for settlement of the purchase or sale of a security, without any modification or extension of that date.

(9) "Maturity date" means the date on which a security matures, and shall not mean the call date or the average life of the security.

(10) "Adjusted trading" means any method or transaction used to defer a loss whereby a Federal credit union sells a security to a vendor at a price above its current market price and simultaneously purchases or commits to purchase from that vendor another security above its current market price.

(11) "Bailment for hire contract" means a contract whereby a third party bank or other financial institution for a fee agrees to exercise ordinary care in protecting the securities held in safekeeping for its customers.

(12) "Short sale" means the sale of a security not owned by the seller.

(13) "Market price" means the last established price at which a security is sold.

(b) *Limitations.* (1) A Federal credit union may contract for the purchase or sale of a security authorized by section 107(7) of the Act, provided that the delivery of the security is to be made within thirty (30) days from the trade date.

(2) A Federal credit union may not enter into a standby commitment to purchase or sell a security.

(3) A Federal credit union may enter into a cash forward agreement to purchase a security provided that the period from the trade date to the settlement date does not exceed one hundred and twenty (120) days and the credit union has written cash flow projections evidencing its ability to purchase the underlying security. A Federal credit union may not enter into a cash forward agreement to sell a security unless it presently owns the security. All cash forward agreements must be settled on a cash basis at the settlement date.

(4) A Federal credit union may not enter into an investment-type repurchase transaction unless all the conditions cited in § 703.3(a)(4)(A) are met. Any repurchase transaction that does not meet such requirements constitutes a loan-type repurchase transaction subject to the limitations of § 703.3(b)(5). The purchase price of a security obtained under an investment-type repurchase transaction must be at the market price.

(5) A Federal credit union may enter into a loan-type repurchase transaction only with its own members, other credit unions, or approved credit union organizations that are defined in § 701.27-2 of the rules and regulations.

(6) A Federal credit union may enter into a reverse repurchase transaction, provided that the funds obtained are not invested under section 107(7)(I) of the Act. Furthermore, either any investment or deposit made under sections 107(7)(B), (D), (E), (F), (G), (H) or 107(8) of the Act or any security collateralizing the reverse repurchase transaction must have a maturity date not later than the settlement date for the reverse

repurchase transaction. The maximum amount of funds that may be borrowed under a reverse repurchase transaction for investment or deposit is 10 percent of paid-in and unimpaired capital and surplus.

(7) A Federal credit union may not buy or sell a futures contract unless the purchase or sale is specifically authorized by a regulation issued by the Administration.

(8) A Federal credit union may not engage in adjusted trading as defined in § 703.3(a)(10).

(9) A Federal credit union may not engage in a short sale as defined in § 703.3(a)(12).

(10) All purchases and sales of securities by a Federal credit union by means of a cash transaction under § 703.3(b)(1) or a cash forward agreement under § 703.3(b)(3) must be at the market price.

[FR Doc. 79-[illegible] Filed 7-18-79; 8:45 am]

BILLING CODE 7535-01-M

No. 83-183

IN THE

Supreme Court of the United States

OCTOBER TERM, 1983

LTV FEDERAL CREDIT UNION,
Petitioner,

v.

UMIC GOVERNMENT SECURITIES, INC., and
BANCO DE LA NACION ARGENTINA,
Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

---

BRIEF OF THE RESPONDENTS IN OPPOSITION

S. SHEPHERD TATE
(Counsel of Record)
W. THOMAS HUTTON
SHEPHERD D. TATE
MARTIN, TATE, MORROW
& MARSTON, P.C.
705 Union Planters National
Bank Building
Memphis, Tennessee 38103
(901) 525-5881
Attorneys for Respondent,
UMIC Government Securities, Inc.

KERRY C. SMITH
(Counsel of Record)
PETTIT & MARTIN
600 Montgomery Street
21st Floor
San Francisco, California 94111
(415) 434-4000
Attorneys for Respondent,
Banco de la Nacion Argentina

WILSON - EPES PRINTING CO., INC. - 789-0096 - WASHINGTON, D.C. 20001

COUNTER STATEMENT OF QUESTIONS PRESENTED

Whether, because of recent amendments to the federal securities laws which include puts and options on securities within the statutory definition of a "security", this Court should determine if puts and options on securities fell within the statutory definition of a "security" prior to the amendments.

Whether the decision of the Court of Appeals in declining to apply retroactively recent amendments to the federal securities laws to the June 28, 1978 Standby Commitment affords petitioner any basis for review on writ of certiorari.

Whether the Court of Appeals decision that UMIC was not an unregistered "exchange" affords petitioner any basis for review on writ of certiorari.

Whether the Court of Appeals holding that the broad powers given to federal credit unions under the Federal Credit Union Act gave petitioner the power to enter into the contract in question affords petitioner any basis for review on writ of certiorari.

TABLE OF CONTENTS

TABLE OF AUTHORITIES

TABLE OF AUTHORITIES—Continued

In The
Supreme Court of the United States
October Term, 1983

No. 83-183

LTV Federal Credit Union,
Petitioner,
v.

UMIC Government Securities, Inc., and
Banco de la Nacion Argentina,
Respondents.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Fifth Circuit

---

BRIEF OF THE RESPONDENTS IN OPPOSITION

COUNTER STATEMENT OF THE CASE

A. Proceedings and Disposition in the Courts Below.

This suit was filed by LTV Federal Credit Union ("LTV") on June 24, 1980, in the United States District Court for the Northern District of Texas, Dallas Division. LTV sought a declaratory judgment to sanction its unilateral breach of a standby commitment agreement ("Standby Commitment") to purchase $4 million Government National Mortgage Association certificates ("GNMAs") from UMIC Government Securities, Inc. ("UMIC"). One day later UMIC filed a complaint for breach of contract and securities fraud against LTV and certain of its directors. Later Banco de la Nacion Argentina ("Banco") was joined as a plaintiff and counter-complainant with UMIC. The cases were consolidated and tried without a

jury. The District Court (Patrick E. Higginbotham, J.) found that LTV's breach of the Standby Commitment was intentional and that LTV was liable in damages to UMIC and Banco for breach of contract in the aggregate amount of $1,525,647.91.

In the District Court LTV raised "a fistful of arguments to justify its contention that the contract was not enforceable" (App. p. A-17),[1] all of which were rejected by the court. Among its defenses, LTV claimed that the Standby Commitment was an unregistered "security" within the meaning of the Securities Act of 1933, 15 U.S.C. §§ 77a *et seq.*; that UMIC violated the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a *et seq.*, by acting as an unregistered "exchange"; and that LTV was not authorized by the Federal Credit Union Act, 12 U.S.C. §§ 1751 *et seq.*, to enter into the Standby Commitment. These same contentions were made in the Court of Appeals, were rejected, and are again raised in LTV's Petition to this Court.

The Court of Appeals held that the findings of fact and conclusions of law of the District Court were proper and the Court of Appeals adopted the District Court's opinion with some slight amplification on one issue. This amplification was due to the fact that during the period of time the case was on appeal the federal securities laws were amended expressly to include, *inter alia*, options on securities within the definition of a "security." In affirming the District Court, the Court of Appeals held that these amendments should not be applied retroactively in this case.

B. Nature of the Case.

On June 26, 1978, LTV, a federal credit union with its principal place of business in Texas, and UMIC, a Tennessee corporation organized for the purpose of trans-

---

[1] References to Petitioner's Petition For A Writ Of Certiorari are made by "Pet. p. —"; references to the Appendix to Petitioner's Petition For A Writ Of Certiorari are made by "App. p. —".

acting business in government securities, entered into a contract, described as a Standby Commitment, whereby in return for a $200,000 non-refundable commitment fee, LTV, upon twenty days notice, was obliged to take delivery and pay for on June 22, 1980, certain Government National Mortgage Association certificates (GNMAs). During the approximate two-year duration of the Standby Commitment, the market value of the GNMAs declined. UMIC gave timely written notice to LTV that it would deliver the GNMAs pursuant to the Standby Commitment; however, on June 17, 1980, LTV informed UMIC that it would not take delivery or pay for the GNMAs. One week later LTV filed its declaratory judgment action and this consolidated action was commenced.

C. Facts in the Record Necessary to Understand the Issues.

In its Petition (Pet. pp. 4-7) petitioner has made many statements of "fact" which are not only unsupported by the record but are also directly contrary to the findings of the District Court and the Court of Appeals.[2] Respondents reject petitioner's version of the underlying facts and, instead, adopt the findings of fact of the District Court and the Court of Appeals.

SUMMARY OF ARGUMENT

The Court of Appeals decision affords petitioner no basis for review by this Court.

A. The issue of whether the Standby Commitment was a "security" under the federal securities laws when it was made in 1978 does not warrant this Court's review. The Standby Commitment was a purely private transaction between two private parties. Because the October 1982 amendments to the federal securities laws included puts and options within the literal definition of a federal "security" and changed the applicable law, there is no ele-

---

[2] See p. 8 n.8, *infra*.

ment of public importance involved in this private transaction, nor would a decision of this Court serve to benefit the development of federal law. This Court should not, therefore, grant the Petition.

B. The Court of Appeals determination not to apply retroactively the 1982 amendments to the Standby Commitment (which was made in June 1978) was reached through a factual determination which, as this Court has often held, does not afford a basis for review by this Court.

C. The Court of Appeals determination that UMIC was not an "exchange" as defined by the Securities Exchange Act, 15 U.S.C. § 78c(a)(1), was also based on a factual determination which, again, affords petitioner no basis for review by this Court.

D. At the time the Standby Commitment was made the National Credit Union Administration ("NCUA") interpreted the National Credit Union Act as authorizing standby commitment agreements. When the NCUA adopted regulations in 1979, prohibiting certain standby commitment agreements, it expressly instructed credit unions such as petitioner to honor their outstanding standby commitment agreements. Petitioner has urged no valid basis for this Court's review of the lower courts' interpretation of the National Credit Union Act as authorizing the Standby Commitment.

REASONS FOR DENYING THE PETITION

A. Because of recent amendments to the federal securities laws which include puts and options on securities within the statutory definition of a "security", this Court should not determine if puts and options on securities fell within the statutory definition of a "security" prior to the amendments.

The Court should not grant petitioner's request to review the Court of Appeals determination that the Standby Commitment, when made, was not a "security" which was required to be registered under Section 5 of the Securi-

ties Act of 1933, 15 U.S.C. § 77e. Contrary to petitioner's assertions, there is neither an uncertainty within the circuits nor a need for a "definitive statement" from this Court regarding whether the Standby Commitment was a "security" in 1978, subject to registration. The Court of Appeals decision is entirely in accordance with the settled law and otherwise does not warrant this Court's consideration.

Initially, it is important to note that the question advanced by petitioner lacks public importance because on October 13, 1982, the federal securities laws were amended expressly to include, *inter alia*, puts and options on securities within the definition of a "security". Pub. L. No. 97-303, 96 Stat. 1409 (App. p. A-6). The issue of whether the Standby Commitment—a "purely private transaction between two private parties" (App. p. A-13) —was a federal "security" in June 1978, when it was made, simply does not merit consideration by this Court. *See, e.g., District of Columbia v. Sweeney*, 310 U.S. 631 (1940) (certiorari denied "in view of the fact that the tax is laid under a statute which has been repealed and the question is therefore not of public importance"); *Morris v. Weinberger*, 410 U.S. 422 (1973) (writ of certiorari dismissed as improvidently granted when Congress amended statute following grant of writ of certiorari).

Further, there is no split within the circuits as to whether a standby commitment agreement is a "security" subject to registration. Apart from the Court of Appeals in the instant case, the only other court of appeals that has considered the issue held squarely that a standby commitment agreement is not, itself, a security subject to registration. *Securities and Exchange Commission v. G. Weeks Securities, Inc.*, 678 F.2d 649, 652 (6th Cir. 1982).[3]

---

[3] Prior to having its opinion vacated by this Court the Seventh Circuit reached a similar holding with respect to exchange traded

As to the three court of appeals decisions cited by petitioner for its "conflict within the circuits" claim, two are readily distinguishable[4] and the third, *Mansbach v. Prescott, Bell & Turben*, 598 F.2d 1017 (6th Cir. 1979), fails to stand for the proposition urged by Petitioner.[5] There is simply no conflict within the Courts of Appeals.

Finally, even if registration were required for pre-amendment option contracts covering the sale of GNMAs, parties such as petitioner would be afforded little, if any, additional protection under the federal securities laws. As noted by the Court of Appeals, petitioner failed to assert any "claim of real prejudice resulting from UMIC's failure to register the standby agreement as a

---

options on GNMAs. *Board of Trade of the City of Chicago v. Securities and Exchange Commission*, 677 F.2d 1137, 1155-57 (7th Cir.), *vacated as moot*, —— U.S. ——, 103 S.Ct. 434, 74 L.Ed.2d 594 (1982).

[4] The loan commitment letter in *United States v. Austin*, 462 F.2d 724 (10th Cir.), *cert. denied*, 409 U.S. 1048 (1972), involved

> a large scale, advance-fee, loan swindle in which the defendants issued, along with false financial statements, not outright commitments, but back-up commitments guaranteeing the making of loans by others. Plaintiffs were induced to put up money by advertising and solicitation and no loans were ever made.

McGovern Plaza Joint Venture v. First Denver Mortgage Investors, 562 F.2d 645, 648 (10th Cir. 1977). And, apart from being distinguishable on its facts, in a subsequent decision holding that routine loan commitments are *not* securities, the Tenth Circuit limited *Austin* to its own facts. *McGovern Plaza*, 562 F.2d at 648.

The naked double options described in *Securities and Exchange Commission v. Commodity Options International, Inc.*, 553 F.2d 628 (9th Cir. 1977), also have no characteristics similar to the Standby Commitment; the instruments were merely a facade masking a classic investment contract under *Securities and Exchange Commission v. W. J. Howey Co.*, 328 U.S. 323 (1946).

[5] *Mansbach*, 598 F.2d at 1026 n.40, contains dicta to the effect that an option to sell stock is a separate security; however, in *Securities and Exchange Commission v. G. Weeks Securities, Inc.*, 678 F.2d 649, 652 (6th Cir. 1982), the Sixth Circuit expressly held that a standby commitment agreement was not a separate security.

security" (App. p. A-5 n.1). Moreover, because the standby commitment agreement involved the sale of GNMAs, which are "securities"—albeit exempt securities—LTV was afforded the full protection of the antifraud provisions of the securities laws such as Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5 promulgated thereunder. *See International Brotherhood of Teamsters v. Daniel*, 439 U.S. 551, 564 n.18 (1979); *Abrams v. Oppenheimer Government Securities, Inc.*, [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,409 (N.D. Ill. Jan. 3, 1983); *Davidson v. Dean Witter Reynolds, Inc.*, 478 F. Supp. 494, 495 (D. Colo. 1979).

B. The decision of the Court of Appeals in declining to apply retroactively recent amendments to the federal securities laws to the June 28, 1978 Standby Commitment affords petitioner no basis for review on writ of certiorari.

Petitioner claims that in declining to apply retroactively the October 1982 amendments to the federal securities laws[6] to the June 20, 1978 Standby Commitment, the Court of Appeals decision "is directly in conflict with the consistent line of decisions from this Court for the last 182 years on the issue of retroactive application of statutory changes which occur during the pendency of direct review." (Pet. p. 15). To the contrary, the Court of Appeals decision is in complete accord with the directive of this Court in *Bradley v. Richmond School Board*, 416 U.S. 696, 711 (1974):

> [A] court is to apply the law in effect at the time it renders its decision, *unless doing so would result in manifest injustice* or there is statutory direction or legislative history to the contrary.

(emphasis added). The Court of Appeals simply made a factual determination that the retroactive application of

---

[6] Pub. L. No. 97-303, 96 Stat. 1409.

the October 1982 amendments would result in "manifest injustice" in this case and, in accordance with the directive in *Bradley*, applied the law in effect at the time the Standby Commitment was made.[7]

In attacking the finding of the Court of Appeals that the retroactive application of the amendments would be manifestly unjust, and which would, in the opinion of the Court of Appeals, subject UMIC to "unforeseen, disastrous consequences" (App. p. A-16), petitioner charges that the Court of Appeals "incorrectly characterizes" certain facts in the record (Pet. p. 16).

Petitioner is attempting to re-litigate the facts in this Court; and, in doing so, continues to make statements of "fact" which are not only unsupported by the record but which are directly contrary to findings of the District Court and the Court of Appeals.[8] In any event, however,

---

[7] The Court of Appeals also found that there was no direction in the legislation concerning its prospective or retroactive application (App. p. A-11).

[8] For example, petitioner claims that LTV's management was untrained and inexperienced in matters involving investments (Pet. p. 5) and was somehow misled by UMIC (Pet. pp. 5-6). The Court of Appeals, in adopting the findings of the District Court, expressly held to the contrary:

> First, the parties to this lawsuit are reasonably sophisticated parties, knowledgeable of financial transactions, who negotiated and entered a single contract. Each had entered similar contracts with other institutions and corporations, and the court below specifically found that each party to the contract understood the contents of the agreement and the method of its operation. There was no fraud involved in either the inducement or the execution of the agreement; the agreement was a legal contract, a purely private transaction between two private parties. Each party to the agreement hoped to profit from a change in the market, and this litigation sprang from LTV's realization that it would not so profit. Each party has been equally capable of prosecuting its respective claims in this court and the court below.

(App. pp. A-12-13)

this Court should not grant the petition simply to review the factual findings of the Court of Appeals. As stated in *National Labor Relation Board v. Pittsburgh Steamship Co.*, 340 U.S. 498, 503 (1951):

> This is not the place to review a conflict of evidence nor to reverse a Court of Appeals because were we in its place we would find the record tilting one way rather than the other, though fairminded judges could find it tilting either way. It is not for us to invite review by this Court of decisions turning solely on evaluation of testimony where on a conscientious consideration of the entire record a Court of Appeals under the new dispensation finds the Board's order unsubstantiated.
>
> In such situations we should "adhere to the usual rule of noninterference where conclusions of Circuit Courts of Appeals depend on appreciation of circumstances which admit to different interpretations." Federal Trade Com. v. American Tobacco Co., 274 U.S. 543, 544, 71 L. Ed. 1193, 1194, 47 S. Ct. 663.

Petitioner also places some significance on the decision of this Court to vacate the Seventh Circuit's decision in *Board of Trade of the City of Chicago v. Securities and Exchange Commission*, 677 F.2d 1137 (5th Cir.), *vacated as moot*, —— U.S. ——, 103 S.Ct. 434, 74 L.Ed.2d 594 (1982) (Pet. p. 11). No inference should be drawn from the Court's action because *Board of Trade* was based on *United States v. Munsingwear, Inc.*, 340 U.S. 36 (1950), which sets forth this Court's established practice in federal civil cases which become moot on appeal, of granting the petitions, reversing or vacating the judgments, and remanding the cases with directions to dismiss the petitions for review as moot. As was explained in *Munsingwear*:

> That procedure clears the path for future relitigation of the issues between the parties and eliminates a judgment, review of which was prevented through

> happenstance. When that procedure is followed, the rights of all parties are preserved. . . .
>
> * * * *
>
> As already indicated it is commonly utilized in precisely this situation to prevent a judgment, unreviewable because of mootness, from spawning any legal consequence.

340 U.S. at 40-41.

The Court of Appeals determination not to apply retroactively the October 1982 amendments is neither in conflict with any decision of this Court nor of the decisions of any of the other circuits, and this Court should not grant the Petition merely to review the findings of fact on which the decision is based.

C. The Court of Appeals decision that UMIC was not an unregistered "exchange" affords petitioner no basis for review on writ of certiorari.

Petitioner contends that its Petition should be granted because the decision of the Court of Appeals is the first interpretation of the definition of the term "exchange" under the Securities Exchange Act,[9] and the decision has completely "emasculated the definition and straight forward criteria set forth therein." (Pet. p. 20).

Petitioner's claim represents an effort to re-try the facts and petitioner's version of the facts is in direct conflict with the findings of the District Court, as adopted by the Court of Appeals:

> This court does not agree that UMIC operates as an "exchange." UMIC does not use its facilities or

---

[9] An exchange is defined in 15 U.S.C. § 78c(a)(1) as:

> any organization, association, or group of persons, whether incorporated or unincorporated, which constitutes, maintains, or provides a market place or facilities for bringing together purchasers and sellers of securities or for otherwise performing with respect to securities the functions commonly performed by a stock exchange as that term is generally understood, and includes the market place and the market facilities maintained by such exchange.

> otherwise provide a marketplace for bringing together purchasers and sellers of securities. Nor does UMIC perform the functions commonly performed by a stock exchange.

(App. p. B-42).

The opinion of the District Court as adopted by the Court of Appeals simply found that a necessary element of an "exchange" is an agency relationship—a relationship which the proof showed was not involved in the case of UMIC and its operations (App. pp. B-42-43). The opinion is accordingly limited to the factual situation of this particular case, and presents no conflict with the decision of any other circuit. Again, this Court should not grant the Petition simply to review the findings of fact on which the decision is based. *National Labor Relation Board v. Pittsburgh Steamship Co.*, 340 U.S. 498, 503 (1951).

D. The Court of Appeals holding that the broad powers given to Federal Credit Unions under the Federal Credit Union Act gave petitioner the power to enter into the contract in question affords petitioner no basis for review on writ of certiorari.

With little argument, and without citing any authority for its contention, petitioner seeks to have this Court overrule the holding of the Court of Appeals that under the Federal Credit Union Act, 12 U.S.C. §§ 1751 *et seq.*, Federal Credit Unions had the power to enter into standby commitment agreements.

The National Credit Union Administration ("NCUA"), the agency charged with the responsibility of administering the Federal Credit Union Act, recognized that prior to 1979 federal credit unions were authorized to enter into standby commitment agreements. In the District Court's opinion, which was adopted by the Court of Appeals, Judge Higginbotham acknowledged the stipulation that had been made by the parties prior to trial:

> The parties have stipulated that at the time the Standby Commitment was executed, the NCUA "interpreted the Federal Credit Union Act as authorizing Federal Credit Unions, such as LTV Credit Union, to enter into and consummate GNMA standby commitments."

(App. p. B-21).

Petitioner had previously entered into standby commitment agreements with other institutions and corporations. (App. p. A-13). Petitioner has offered no basis for disturbing the stipulation and the lower court's reading of the Federal Credit Union Act. The opinion of the Court of Appeals should not, therefore, be reviewed by this Court.

Petitioner also argues that the Court of Appeals erred in refusing to retroactively apply NCUA regulations prohibiting certain standby commitment agreements [10] after July 20, 1979—more than one year after the parties entered into the Standby Commitment. The regulations were clearly prospective in their application and, in fact, the NCUA urged federal credit unions to meet their outstanding standby commitment agreements. The NCUA stated:

> Some commenters expressed concern over whether the final rule would be applicable to the transactions entered into before its effective date. *The final rule is not retroactive and, therefore, does not affect transactions entered into prior to the effective date* [July 20, 1979].
>
> * * * *
>
> As a general rule, those Federal credit unions that have previously entered into a suitable commitment to purchase a security even if the commitment is not authorized under the final rule, *should meet that commitment.*

44 *Fed. Reg.* 42,676 (July 20, 1979) (emphasis added).

---

[10] The regulations, 12 C.F.R. § 703.3, prohibited only certain standby commitment agreements. For example, federal credit unions were permitted to enter into standby commitment agreements for the purchase and sale of real estate loans, 12 C.F.R. § 703.3(a)(1).

The NCUA's prospective application of the July 1979 regulations was entirely proper and affords Petitioner no basis for review by this Court.

CONCLUSION

As the Court of Appeals noted, this case involves "a purely private transaction between two private parties" (App. p. A-13). For the most part, the applicable law has changed since the Standby Commitment was made and, as is evident from the petition, most of petitioner's arguments focus on the facts surrounding the transaction, all of which have been exhaustively analyzed by the lower courts. Viewed against this background, any ultimate pronouncement on the issues by this Court would not serve to benefit the development of federal law or serve any public purpose. Respondents respectfully request the Petition be denied.

Respectfully submitted,

S. SHEPHERD TATE
(Counsel of Record)
W. THOMAS HUTTON
SHEPHERD D. TATE
MARTIN, TATE, MORROW & MARSTON, P.C.
705 Union Planters National Bank Building
Memphis, Tennessee 38103
(901) 525-5881
Attorneys for Respondent, UMIC Government Securities, Inc.

KERRY C. SMITH
(Counsel of Record)
PETTIT & MARTIN
600 Montgomery Street
21st Floor
San Francisco, California 94111
(415) 434-4000
Attorneys for Respondent, Banco de la Nacion Argentina